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Directorate of
Intelligence

China's Economy in 1995-97

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December 1997

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Summary

Information available as of 15 October 1997 was used in this report.

Since 1995 China's economy has maintained rapid growth while inflation has steadily declined, allowing China's top leaders by yearend 1996 to claim success in their program to secure a soft landing for the economy:

- The 12-month increase in retail prices—China's headline inflation statistic—dropped steadily from over 21 percent in January 1995 to zero by September 1997, almost certainly exceeding the Chinese Government's expectations for lowering inflation.

- Real growth in gross domestic product slowed gradually from 12.6 percent in 1994 to 9.7 percent in 1996. Despite widespread expectations of an economic upturn this year, in the first three quarters of 1997 the growth of GDP, investment, and prices continued to slow.

- Foreign trade's contribution to growth dropped sharply in 1996 but has rebounded this year, pushing China's global trade surplus to $30.5 billion for the first nine months. Continuing large foreign investment inflows also helped push official foreign exchange reserves to over $134 billion by the end of September 1997.

Beijing in 1995 and 1996 employed a variety of administrative and market-oriented measures to successfully steer the economy to a soft landing, but several factors stand out. First, senior officials repeatedly affirmed the government's commitment to maintaining "relatively" tight monetary policies, and, indeed, monetary growth was slower. The growth of currency and demand deposits dropped from 27 percent in 1994 to 19 percent in 1996. In addition, central authorities tightened controls on new investment. Total investment grew about 18 percent in nominal terms in both 1995 and 1996, down from 37 percent in 1994. Faster agricultural growth also helped slow inflation by restraining food price increases. China recorded record grain harvests of 467 million and 490 million metric tons in 1995 and 1996, respectively. Finally, central and local authorities have increasingly relied on direct intervention in food markets—such as price supervision—to curb price rises.

Although senior leaders touted the soft landing, Beijing's tighter macroeconomic policies exacted a cost. Unsold inventories of industrial goods increased to 520 billion yuan at the end of last year—about 8 percent of GDP. Excess capacity and rising inventories contributed to deteriorating state enterprise performance. Industrial state enterprises recorded a net loss

APLA 97-10008
December 1997

in 1996, according to Chinese statistics, for the first time since economic reforms began in 1978. In addition, tighter credit policies led to higher unemployment and increasing numbers of labor disturbances.

In part because of the structural problems exposed by tighter credit policies, senior leaders increasingly promoted economic restructuring—and in particular state enterprise reform—as the new top policy priority:

- Beijing since 1996 has started implementing the new strategy adopted in 1995 under which the central government focuses its support and supervision on 1,000 of the largest state enterprises while granting local governments greater leeway to pursue ownership reforms in smaller state firms. A substantial proportion of new bank lending in 1996, for example, went to 300 large state enterprises selected as the best performers among the 1,000 "backbone" enterprises.

- Central authorities also gradually reduced subsidized lending to smaller state firms and endorsed locally initiated reforms for smaller state firms including sale, lease, merger, and transformation into shareholding companies. A dominant theme of Beijing's enterprise reform plans in 1997 has been preparing for more "bankruptcies, mergers, and reemployment."

- In addition, Beijing has continued to implement reforms intended to gradually transform the state banks into commercially viable operations. In August 1996, for example, Beijing issued new loan regulations tightening loan criteria, and this year authorities have taken a series of measures to prevent bank funds from flowing into stock markets, with the aim of reducing risk in the financial system.

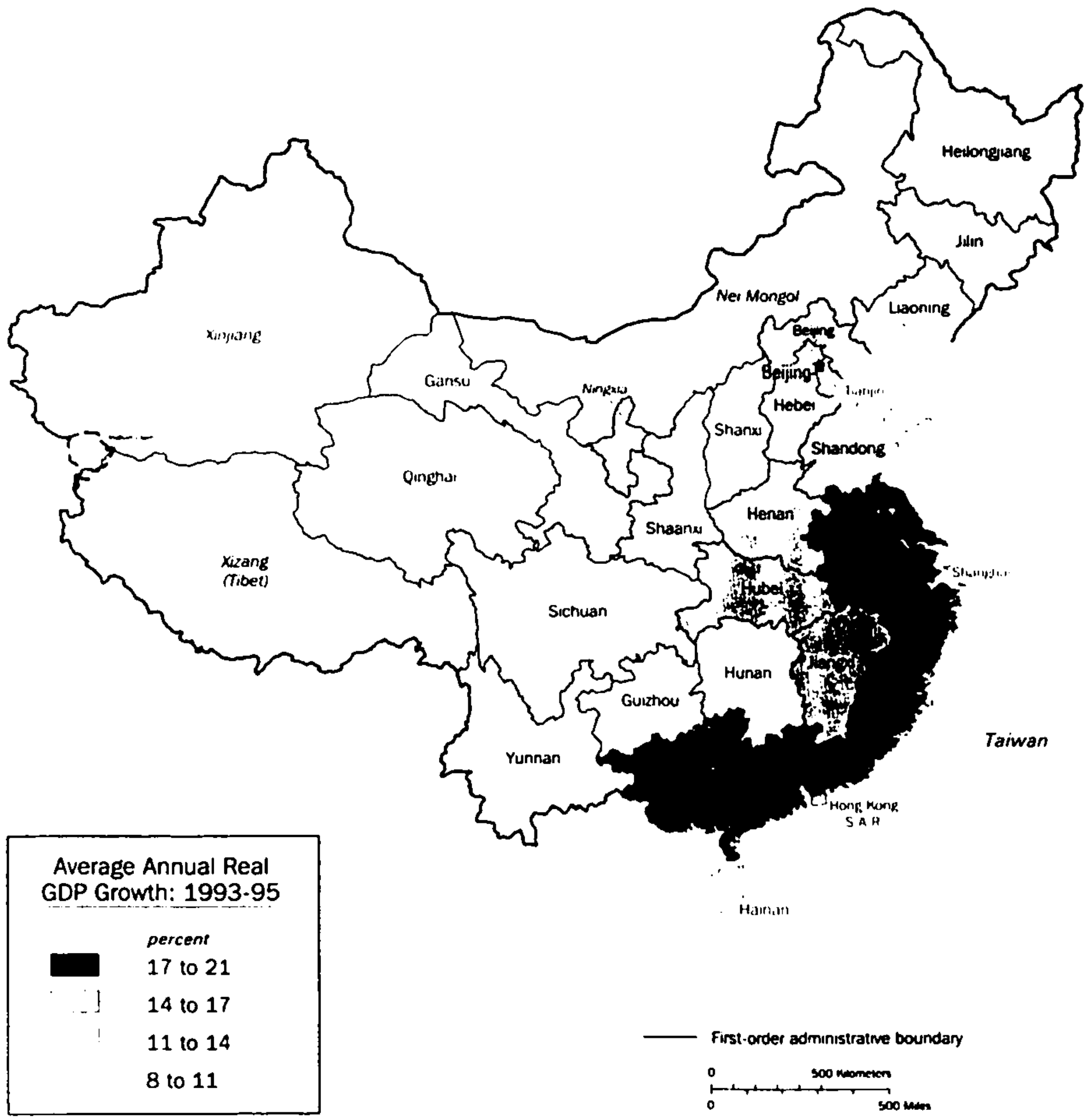
In 1997, the Chinese economy continued to cool as real GDP in the first three quarters grew just 9 percent—the slowest rate since 1991. This was in part due to Beijing's decision to accelerate difficult structural reforms. Central authorities' stress on layoffs and bankruptcies, for example, probably helped restrain wage increases; real urban per capita income in the first three quarters grew just 3 percent year-on-year, as compared with a 7-percent average annual increase since 1990. In addition, excess capacity in many industries and the massive overhang of unsold inventories discouraged new investment; in the first three quarters investment grew just 11 percent year-on-year. Beijing also continued relatively tight monetary policies aimed at avoiding a resurgence in inflation; monetary growth (M1) slowed to 17 percent in the year through September 1997.

Today Beijing faces a series of difficult tradeoffs. Central leaders' policies and statements show that, in their view, the government must push ahead

with difficult reforms to sustain long-term growth. These reforms risk social unrest—such as plant closings and increased unemployment—and may slow growth in the short term. Putting off these reforms, however, will merely raise their ultimate cost; nonperforming loans are already equal to over 18 percent of GDP, according to Chinese statistics. At the same time, policymakers seek to maintain rapid enough growth to avoid destabilizing levels of unemployment, while avoiding a new cycle of economic overheating and high inflation. The Ministry of Labor estimates that employing displaced workers and new entrants into the labor force will require 54 million new jobs in urban areas during the Ninth Five-Year Plan (1996-2000), but that, without government intervention, the economy will only generate 38 million.

Although the recently concluded 15th Communist Party Congress reaffirmed the leadership's commitment to market-oriented reforms, what type of market economy eventually results is still undetermined. Many of the current enterprise reform initiatives that President Jiang Zemin endorsed in his keynote address at the Congress—the stress on mergers and building large enterprise groups or conglomerates, for example—appear likely to raise the concentration of economic power. These reforms could yield a system dominated by state-affiliated conglomerates in which a few interest groups have an inordinate effect on government policy. On the other hand, Beijing continues to pass new economic legislation and establish institutions that may help to limit arbitrary government intervention in the economy and promote more open competition. Developments during the next three years—a time frame identified by senior Chinese officials to make substantial progress in economic reforms—will help to determine whether China moves toward an economy in which power is concentrated in a few interest groups, or a more transparent system with greater reliance on the rule of law.

Figure 1
China's Regional Growth Patterns



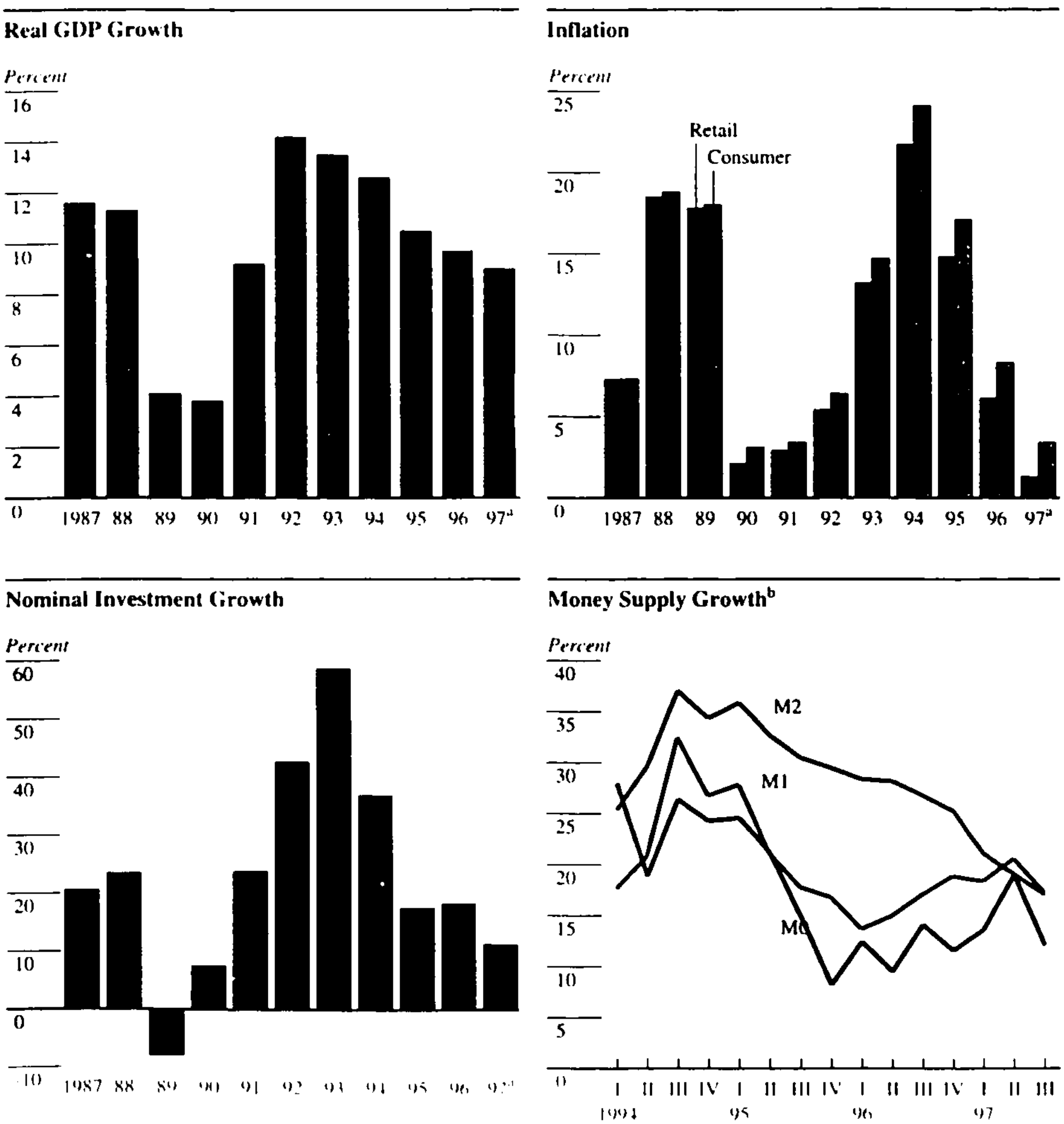
Source: Official Chinese Government statistics.

Boundary representation is not necessarily authoritative.

Contents

Figure 2
China: Macroeconomic Performance

Note scale change



[a] January-September, compared to same period in 1996
[b] Increase over previous 12 months
Source: Official Chinese Government statistics

China's Economy in 1995-97

Macroeconomic Policy Success . . .

Since 1995 China's economy has maintained rapid growth while inflation has steadily declined, allowing senior leaders to claim success in securing a soft landing for the economy. The 12-month increase in retail prices—China's headline inflation figure—dropped from over 21 percent in January 1995 to less than 1 percent by May 1997 and has continued to fall. Moreover, for the first time in over a decade, Beijing substantially lowered inflation without provoking a severe economic downturn. Real GDP growth slowed gradually from 12.6 percent in 1994 to 9.7 percent in 1996, dropping further to 9 percent year-on-year in the first three quarters of 1997.

The unprecedented drop in inflation probably exceeded even the Chinese Government's expectations. Average retail price inflation in 1996 was 6.1 percent, almost 4 percentage points below the 10-percent target the government set early in the year. In the first three quarters of 1997 continued declines have pushed retail price inflation close to zero and led government officials to lower forecasts for the year to 2 percent—which would be the lowest rate since 1983. Beijing's successful negotiation of an economic soft landing is in marked contrast to the historical trend. During the last two decades, the inadequacy of Beijing's traditional administrative policy tools in an increasingly market-oriented economy had led to increasing volatility in China's business cycles, culminating in a severe downturn of 1990, followed by an investment boom that peaked in 1993. The soft landing is all the more surprising in light of the weakness of Beijing's policy tools; in China's transitional economy, both administrative levers and incipient market-oriented instruments are limited in their effectiveness.

Beijing in 1995 and 1996 employed a combination of administrative and market-based measures to steer the economy to a soft landing, including credit quotas, investment restrictions, changes in interest rates, price controls and subsidies, slower growth of government expenditures, and interventions in food markets to boost supplies. Several factors stand out, however, in the anti-inflation program.

"Relatively" Tight Monetary Policies

Beijing's tightening of credit policies in 1995 and 1996 has played an important role in curbing inflation and moderating economic growth. The growth of currency and demand deposits—the monetary aggregate that most closely reflects changes in credit policies for state enterprises—dropped from 27 percent in 1994 to 19 percent in 1996. Senior leaders and banking officials during this period have repeatedly affirmed their commitment to maintaining "relatively" tight monetary policies; the Ninth Five-Year Plan approved in March 1996, for example, set fairly conservative targets for monetary growth from 1996 to 2000. In addition, legal and organizational changes have strengthened the central bank and given the head offices of the state banks more control over lending decisions at the local level. In August 1996, for example, Beijing issued new loan regulations prohibiting new loans to borrowers that have outstanding nonperforming loans.

Although Beijing's monetary policies since 1994 have been markedly tighter than those in 1993 and 1994, China's monetary authorities have avoided a repetition of the severe credit crunch that stalled growth in 1990. Senior officials have repeatedly stressed that the "relatively" tight policies should be applied flexibly, and indeed during the last two years Beijing has alternated between tighter and looser policies on almost a quarterly basis, apparently trying to balance the goals of reducing inflation and avoiding excessive unemployment. For example, central authorities eased credit policies both in the second half of 1995 and the second half of 1996 but in each case sharply tightened policies in the first quarter of the following year to avoid a resurgence in inflation.

Chinese Statistics: Seeing Through a Glass Darkly

Except where indicated, this report draws on figures from Chinese statistical bulletins, published reports, and articles in official press. Despite Beijing's efforts to improve collection and compilation, many Chinese official statistics have shortcomings:

- *Official figures severely underestimate urban unemployment. In addition to the 5.5 million workers registered as unemployed in early 1997, there were about 9 million workers who had been laid off, according to Chinese press.*

- *Official statistics probably overestimated rural residents' per capita income growth in 1996 because of delays—perhaps politically motivated—in recategorizing suburban areas with high average incomes from rural to urban.*

Chinese central officials have taken steps since 1995 to improve statistical accuracy. China revised its statistics law in May 1996, for example, to include penalties for false reporting. Some changes that have improved accuracy have also yielded sharp discontinuities in data series:

- *For example, a decennial industrial census completed this year led the State Statistics Bureau to cut the official number of industrial enterprises from 10 million in 1994 to 7.3 million in 1995. The Bureau also lowered figures for the industrial output of township enterprises by almost 30 percent to correct false reporting, according to Chinese press.*

- *As a result of such errors, Chinese official figures probably somewhat overestimate the growth of total industrial output and GDP, particularly for the early 1990s when collective sector output boomed.*

Despite such problems, Chinese official statistics still are useful for tracking economic performance, if checked for consistency with other evidence. The comment of a private-sector analyst quoted in the Far Eastern Economic Review *probably resonates with most observers of the Chinese economy: "What we do is follow trends. We don't rely on the actual numbers."*

The central bank twice cut interest rates in 1996 in part, according to Chinese official press, to ease pressures on state firms.

Controlling Investment

Another major tool central authorities have used to cool the economy since 1994 is tighter administrative controls on investment, historically the main driver of growth in China. Total investment grew about 18 percent in nominal terms in both 1995 and 1996, down from 37 percent in 1994. Beijing focused particularly on controlling investment by state enterprises that, until this year, had been largely exempt from the threat of bankruptcy and thus had exercised little restraint in their demand for investment funds. State-sector investment growth dropped from 50 percent in 1993—the peak of the business cycle—to 13 percent in both 1995 and 1996.

Central authorities have also tried to limit new investment projects and promote the completion of existing projects; the Ninth Five-Year Plan, for example, calls for "strict control" of new construction. The central government's control over project approvals is limited, however; in the second half of 1996 localities sharply increased new project approvals in response to a loosening of credit.

Central authorities have also called for changes in the sectoral allocation of investment funds. The Ninth-Five-Year Plan advocates concentrating investment in "focal points," such as agriculture, infrastructure and the "pillar" industries—machinery, petrochemicals, electronics, automobiles, and residential construction.

Chinese statistics for 1996 show Beijing achieved some progress in these goals; investment in agriculture, energy, and machinery, for example, grew faster than total investment. Ironically, however, Beijing's industrial policies probably contributed to the sharp increase in new project approvals by local governments in the second half of 1996, which central officials decried in the official press late in 1996 as "blind investment." Since late 1996, Chinese central government officials have attributed state-sector problems to such blind investment by localities, many of which have invested in the same industries trying to gain an early advantage in sectors expected to receive favorable treatment from the center. According to Chinese official press, 23 of China's 30 provinces have their own automobile plants, most of which are far too small to achieve efficiencies of scale.

Lower Food Price Inflation

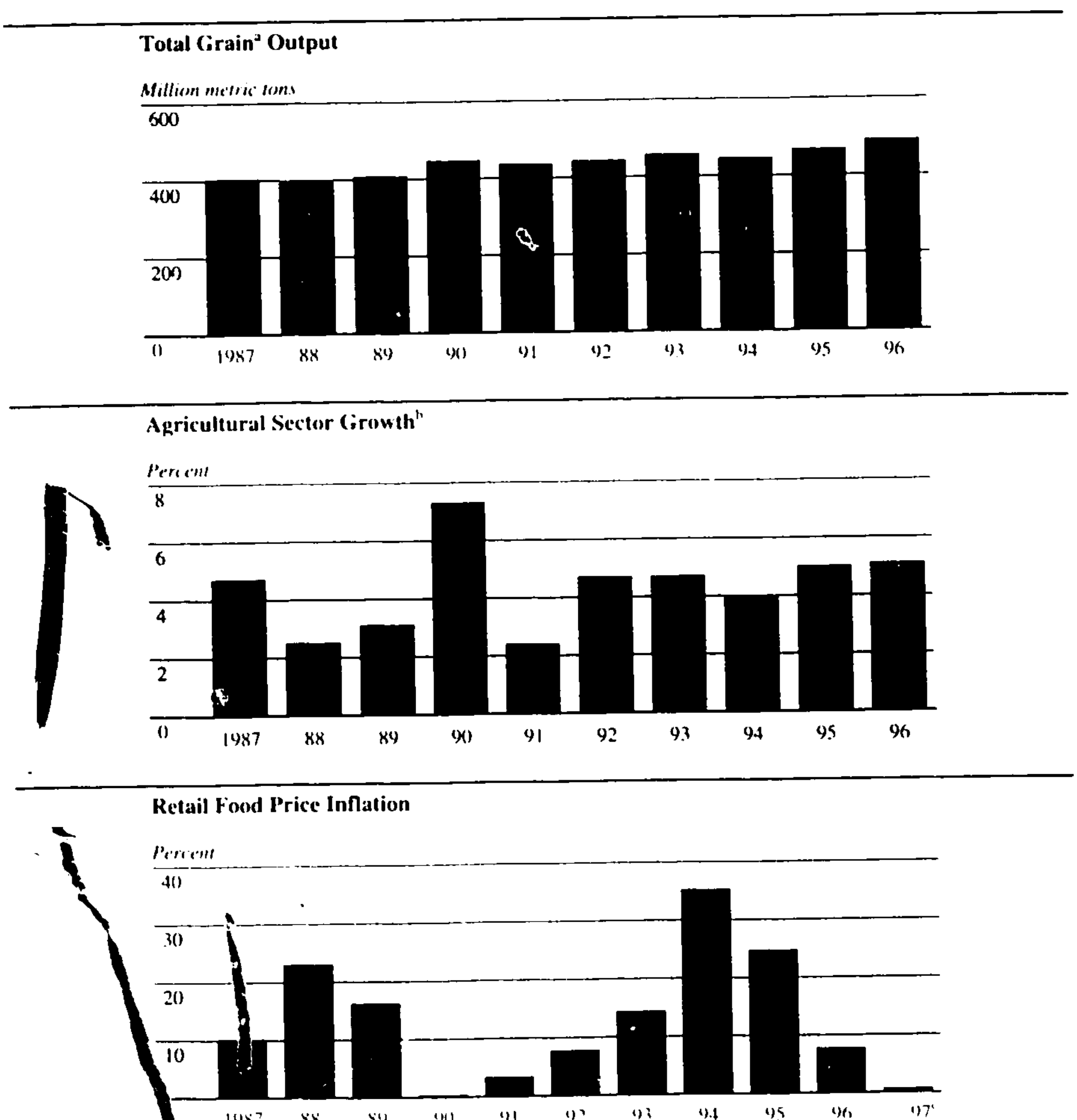
The major determinant of the decline in general inflation during the last two years, however, was lower food price inflation. The annual increase in food prices dropped from 35 percent in 1994 to 8 percent in 1996. Record grain harvests of 467 million and 490 million metric tons in 1995 and 1996, respectively, helped ease pressures on food prices, as grain output grew at almost twice the average rate during the last decade. The second record harvest last year helped push agricultural-sector growth in 1996 to 5.1 percent—the fastest rate since 1990.

Beijing employed a variety of methods to boost agricultural output. Higher prices improved incentives for farmers; an average 40-percent hike in 1994 in state-set procurement prices for grain helped boost output in 1995, and Beijing hiked grain prices another 20 to 30 percent in 1996. In addition, the central bank raised credit allocations—channeled through the Agricultural Bank of China to grain purchasing agencies—to fund state purchases of grain and ensure that farmers received at least the state price for their crop. Such purchases pushed state grain reserves up by 35 million tons last year to reach a record 149 million tons—equal to 30 percent of the 1996 harvest. In 1997, in response to a record summer grain harvest that deflated market prices, central officials ordered local grain bureaus to continue to buy grain at the state floor price to maintain incentives for farmers. Central authorities during the last two years have also taken steps to increase supplies and lower costs of inputs into agricultural production. These include raising credit allocations for investment in agriculture in 1996 and 1997, strengthening supervision of prices for chemical fertilizers last year, and tightening regulations to restrict the loss of farmland to urban development. In May 1997, the State Council issued a directive freezing any new nonagricultural construction on farmland—apart from exceptions formally granted by the State Council—for one year.

In addition, central and local authorities since 1994 have increasingly relied on more direct intervention in food markets to ensure adequate supplies for urban consumers and to moderate inflation. Measures include raising the government share of grain and vegetable retailing, establishing price regulation funds to smooth market fluctuations, subsidizing grain shipments between provinces, using stored grain reserves to ease local shortages, and increasing emphasis on price "supervision." Vice Premier Li Lanqing in June 1996 at a national conference for price control called for stronger supervision of prices for basic necessities, for example. Reversing the long-term trend toward price liberalization, the proportion of retail goods sold at controlled or "guided" prices marginally increased in 1994 and 1995, according to Chinese statistics, and there are signs that reliance on price supervision is increasing. Authorities in Heilongjiang Province in March 1997, for example, announced they would increase price supervision of 30 commodities and services that account for 80 percent of household consumption, according to Chinese official press. Finally, central authorities since 1994 have raised local authorities' incentives to expend effort on agricultural issues by making it part of their job descriptions; under the so-called rice sack and vegetable basket systems provincial governors are held personally responsible for provincial grain supplies and mayors for municipal vegetable supplies.

Figure 3
China: Agricultural Growth and Food Prices

Note scale change



[a] Includes soybeans and tubers.
[b] Real growth of value added of the primary sector.
[c] First eight months.
Source: Official Chinese Government statistics.

Chinese Agriculture: An Uncertain Future

Some Western observers in recent years have raised the prospect that China's often-troubled agricultural sector will have difficulty producing enough food in the future for the country's large and growing population, which would lead to massive agricultural imports and place severe pressure on the world's food supply:

- *These observers point to China's shrinking arable land and serious water shortages. They also note that China's continued economic development will raise living standards and thereby increase demand for animal byproducts, such as meat and eggs, that depend heavily on grain inputs.*

- *The pattern of uneven grain harvests and rising demand that caused the country to become a net grain importer in the late 1980s and again in the early 1990s may reinforce these concerns.*

Other Western agricultural experts, however, argue that China's grain problems—though serious—are manageable if Beijing improves productivity by measures such as increasing irrigation or changing land tenure practices and that predictions of catastrophic shortages are overblown. Senior Chinese officials, for their part, strongly reject claims that their country's future demand for food will wreak havoc on global grain markets:

- *Premier Li Peng told a press conference in early 1996 that Westerners had been mistaken in the past about China's ability to feed its population and they would be proved wrong again.*

- *A study published by the State Council in October 1996 asserts that China will be able to feed itself in the years ahead by enhancing agricultural production through such measures as land reclamation and improved grain storage and transportation.*

At the same time, other officials acknowledge that Chinese agriculture is plagued by serious long-term problems. For example, a report written by the State Science and Technology Commission in 1996 admits that it will be very difficult to meet future goals in per capita grain production because of the declining availability of basic inputs such as land and water:

- *As things now stand, China is trying to feed 22 percent of the global population with only 7 percent of the world's arable land, according to Chinese official statistics.*

- *Efforts to ensure a stable water supply are complicated by the fact that 60 to 80 percent of China's rainfalls during the three months from July through September.*

- *According to an official report, 16 percent of the agricultural workforce is illiterate or semi-illiterate, making expanded use of scientific farming methods problematic. Currently, farmers in developed countries are more than twice as efficient in their use of fertilizers as their Chinese counterparts.*

- *As a result of such problems, some Chinese agricultural experts accept that China will have to import 10 percent or more of its grain in the coming decades.*

Beijing, despite its emphasis on industrial development, says it will do more for agriculture. Officials have pledged, for example, to devote increased funds to agricultural investment and rural development in the coming years. During the Ninth Five-Year Plan (1996-2000), Beijing plans to commit at least 20 percent of its capital spending to agricultural development, according to official press. Boosting efficiency has its downside, however; as productivity increases and available land decreases, more agricultural labor will become redundant. According to official statistics, the agricultural labor surplus grows by 9.3 million people each year, but the expanding rural enterprise sector can absorb only 5.5 million workers per year.

. . . But Tighter Policies Expose Structural Problems

Although senior leaders have touted the soft landing, Beijing's tighter macroeconomic policies during the last two years exacted a cost. Industrial value added grew almost 13 percent in real terms in 1996—down from 18 percent in 1994—but part of this growth was due to increases in unsalable inventories. Stockpiles of industrial goods at yearend 1996 were 520 billion yuan—equal to about 8 percent of GDP. Many state industries—automobiles, televisions, and textiles, for example—were hard hit by the combination of declining demand and excess capacity, due in part to redundant investments by local governments. Capacity utilization was below 60 percent in half of the industries covered in a nationwide decennial survey completed by the government in 1997.

Excess capacity and rising inventories have contributed to deteriorating state enterprise performance. Over 40 percent of state industrial enterprises were in the red during much of 1995 and 1996, according to Chinese statistics, and the proportion would almost certainly be higher if performance were assessed by international accounting standards. Chinese official press reports acknowledged that another 30 percent of state firms were barely profitable, and only one-fifth were securely in the black. Moreover, Chinese statistics[1] showed that in 1996 losses in state industrial enterprises surged 39 percent, and state industry recorded a net loss for the first time since 1949, adding impetus to Beijing's plans to improve state-sector performance.

The combination of declining state enterprise profits and tighter credit policies has led to rising unemployment since 1995. Many state firms, short of operating capital, have sent workers home at sharply reduced or no wages. Although the official urban unemployment rate at yearend 1996 was just 3 percent, this does not include these laid-off workers, many of whom are still technically affiliated with state enterprises. Chinese officials' estimates of the number of these workers suggest actual urban unemployment is at least 7 percent and may be over 10 percent. In some areas of the country, such as the industrial centers of the Northeast, unemployment probably is considerably higher. Rising unemployment and delays in payments of wages have led to increasing numbers of strikes and worker demonstrations; international press, for example, in mid-1997 reported on several separate incidents involving thousands of workers in midsized cities in Sichuan Province. Probably responding to such incidents, Chinese leaders since mid-1996 have stepped up pressure on local authorities to provide more retraining programs for the unemployed and raise unemployment compensation.

Stepping Up Structural Reforms

As inflationary pressures receded in 1996, senior leaders increasingly promoted structural reform as the new top policy priority. The annual national economic work conference in November 1996, for example, called for accelerating economic "restructuring" in 1997, according to Chinese official press. This year, the leadership has continued to stress the importance of accelerating structural changes in the economy and, in particular, state enterprise reforms.

Restructuring State Enterprises

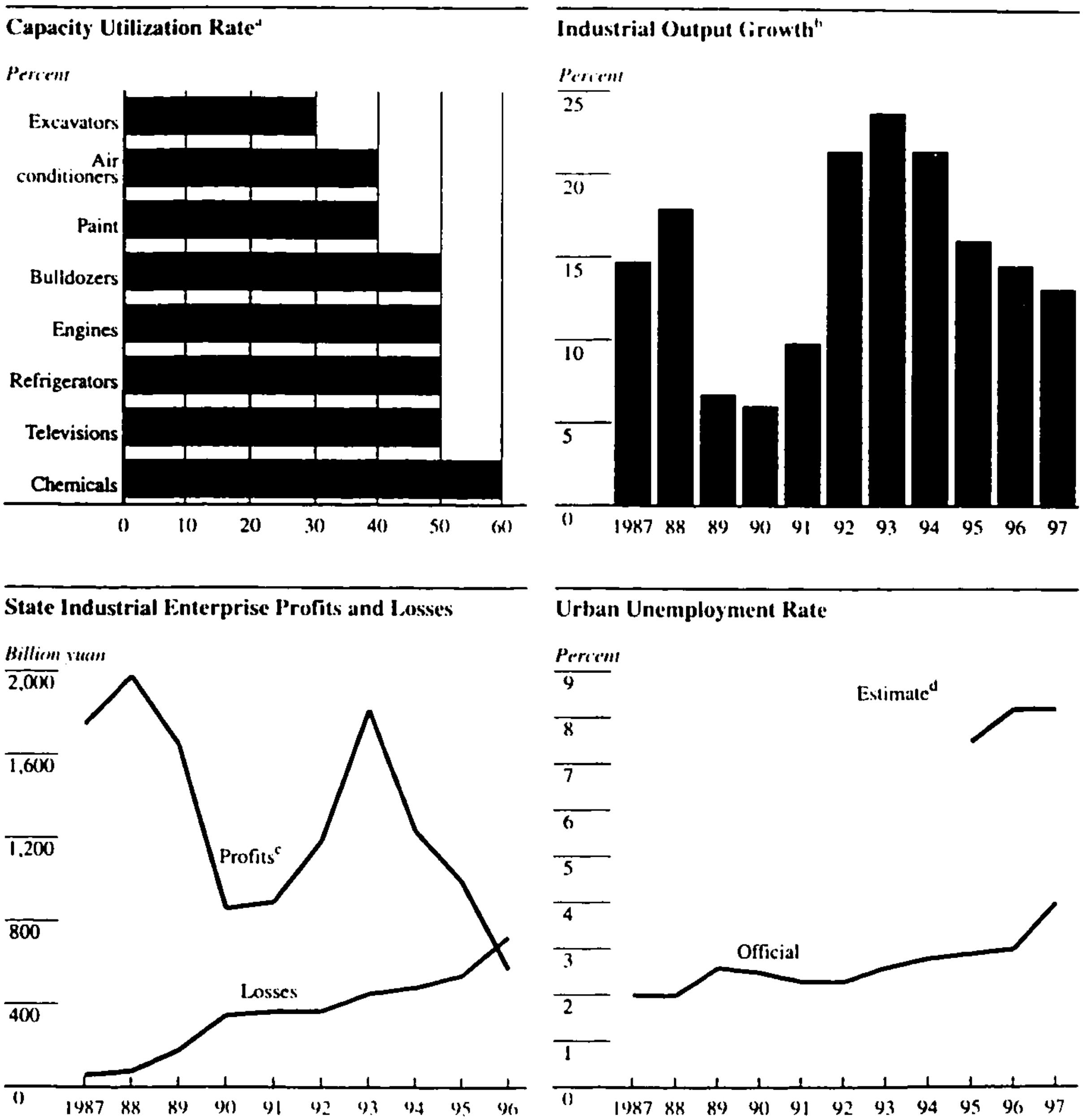
China's senior leaders have routinely declared state enterprise reform a priority in recent years, but in 1997 they raised it to a higher level of precedence, probably responding to poor state-sector performance in 1996. Premier Li Peng, for example, made state enterprise reform the centerpiece of his government work report at the National People's Congress in March, and President Jiang Zemin highlighted enterprise reform issues—in particular, shareholding and other ownership reforms—in his political report at the 15th Communist Party Congress in September.

The New Enterprise Reform Strategy. The groundwork for Beijing's new push was laid in the fall of 1995, when the leadership adopted a new compromise approach, since described in Chinese official press as grasping the large and letting go of the small:

- Under this approach, the central government focuses on reforming a limited number—nominally 1,000—of the largest state enterprises while granting local

Figure 4
China: Cost of the Soft Landing

Note scale change



[a]Mid-1997 estimates cited in Chinese official press.
[b]Gross value of industrial output, at constant prices for township level and above.
[c]From data on aftertax profits and enterprise income tax rates.

[d]Based on estimates cited in Chinese official press of the number of laid-off workers plus the number of registered unemployed.)

Source: Official Chinese Government statistics.

360471AI7 11-97

governments greater leeway to pursue ownership reforms in the over 90,000 smaller state firms. The agreement seeks to allay orthodox concerns about the decline of the state sector by strengthening Beijing's supervision and financial support for larger state firms—the "backbone" of the economy.

- At the same time, it shifts a large part of the burden of maintaining employment levels from Beijing to local governments—small enterprises employ about 60 percent of state enterprise workers, according to Chinese official press.

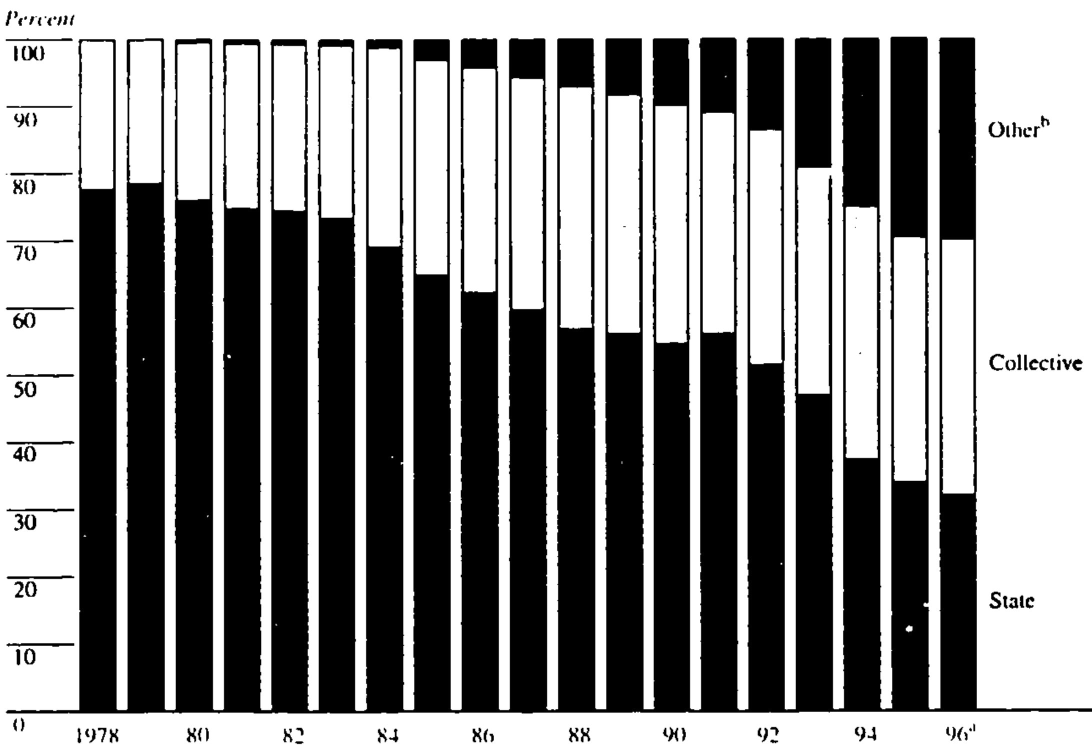
Picking Winners. Chinese press shows that Beijing's goal for the 1,000 large state enterprises is to gradually transform them into self-sufficient, profit-oriented, state-owned companies that have close links to individual state banks and that are increasingly globally competitive—a concept similar to Japanese *keiretsu* and Korean *chaebol*. The Ninth Five-Year Plan, for example, called for China to "strive" to turn some of these large state enterprises into "giant international corporations" during the next five years, and Jiang Zemin's speech at the recent party Congress advocated the establishment of "highly competitive" large enterprise groups with interindustry and international operations. Beijing's basic approach to reforming large state firms is to increase funds for technological upgrading and debt relief while increasing financial supervision. A State Council circular published in 1996, for example, called for key enterprises and state banks to set up joint computer networks to allow the banks to "control and monitor key enterprises' use of capital."

Beijing started implementing this strategy in 1996 by focusing government support on 300 large state enterprises picked by the State Economic and Trade Commission as the best performers among the 1,000 "backbone" enterprises. Much of new bank lending probably went to these enterprises; the head of the China Construction Bank, for example, claimed that fully half its new loans for working capital in 1996 went to 214 large enterprises and enterprise groups, according to official Chinese press. In addition, central officials started the so-called bank sponsor system. Almost all the 300 selected enterprises signed cooperative agreements with individual state banks ensuring them preferential access to credit, according to Chinese official press. Chinese officials also touted progress on a pilot program involving 57 enterprise groups aimed at developing "transregional and intertrade" conglomerates that combine production, marketing, research, and international trade functions. Chinese leaders in 1997 have called for continued focus on selected large state firms. The number of enterprises with special client relationships with state banks will be raised from 300 to 511, according to Chinese press reports. In addition, Beijing raised the number of these experimental enterprise groups from 57 to 120 in May 1997.

Letting the Little Ones Go. The second plank of the new enterprise reform strategy, the "letting go" of smaller state enterprises, could open the door for a substantial increase in "destatization"—the transfer of state assets to collective, private, and foreign firms. Since the fall of 1995, Chinese leaders have endorsed a range of ownership reforms for smaller state firms. Premier Li Peng in his government work report in March 1997, for example, claimed some local governments had "revitalized" many small state firms through means including sale, lease, merger, and transformation into shareholding companies, and President Jiang Zemin in his speech at the recent 15th Party Congress called for faster reform of small state firms through these methods. "The "letting go" strategy also provides a rationale for Beijing to gradually reduce state bank lending to smaller state firms. Because the central government has placed the responsibility for small enterprises squarely on local governments, tighter credit policies will push local governments to press ahead with reforms.

Many local and provincial governments claimed to have made substantial progress in implementing ownership reforms in small state enterprises in 1996 and 1997. Over 70 percent of small state firms in Liaoning Province, for example, underwent some type of property rights reform in 1996, according to the provincial work report. Beijing's major contribution to small enterprise reform was sustaining fairly tight credit conditions for smaller state firms, forcing more layoffs

Figure 5
China: Shares of Industrial Output by Ownership, 1978-96



[a]Estimated from growth rates and 1995 data.
[b]Includes private, foreign-invested, and individual enterprises.
Source: Official Chinese Government statistics.

360482AI7 11-97

of state workers. In addition, central officials have called for emulation of some localities—such as Yibin in Sichuan Province—that have aggressively restructured small state firms. Senior leaders clearly prefer some reform options: Li highlighted sales of state enterprise shares to employees—the so-called joint-stock partnership system—in his government work report in March 1997, for example, and in March 1996 claimed that only a minority of state firms would be sold to the private sector. President Jiang Zemin at the 15th Party Congress also endorsed the joint-stock partnership system.

Expanding Pilot Programs. Premier Li Peng in his government work report earlier this year called for expanding a number of existing pilot enterprise reform programs. In 1997 the number of enterprises

China's Emerging Social Security System

Recognizing the link between state-sector reform—which is aimed in part at eliminating labor redundancy—and the social safety net, Chinese leaders in recent years have been trying to reshape the nation's social security system to fit a market-oriented economy. They are also confronted by a longer term challenge: revamping social welfare programs to meet the needs of a rapidly aging population—the product of China's one-child policy and increased life expectancy. Beijing's ability to manage social security reforms will heavily influence the pace and extent of state-owned enterprise reform, labor mobility, and capital accumulation. The task of building a comprehensive and financially viable social security system is made more difficult by a lack of consensus on policy goals at the national level—several ministries and agencies are involved in social welfare issues—and local officials' reluctance to cede control of pension funds.

The Pension System. *In the past, state enterprises have been responsible for providing old-age pensions to retired workers on a pay-as-you-go basis, using pension premiums allocated for active workers to fund the retirement of older employees. However, the declining ratio of workers to retirees and the growth of the nonstate sector—accounting for more than half the employment in many localities—have prompted officials to launch a set of changes designed to relieve state enterprises of their traditional pension burden:*

- *The Communist Party Central Committee in 1994 urged the establishment of a multipillared system consisting of a basic pension supplemented by enterprise-sponsored pensions and individual retirement savings. Most efforts to date have focused on developing the basic pension, which is meant to provide a minimum standard of living and be financed by contributions from employees, enterprises, and government.*

- *The State Council issued a circular in March 1995 calling for all urban workers to be covered by a single pension system with common standards by the turn of the century. Council members are currently working out the details. A unified plan, however, is problematic partly because the same circular proposed two possible models for the pension system and central officials have allowed localities to choose between the two or any combination.*

- *Recently, groups of enterprises at the regional level have pooled their pension resources to spread risk-sharing and ensure that enterprises with heavy financial burdens are able to pay their retirees. According to the World Bank, different localities have begun offering varying retirement plans to differentiate their schemes from others and retain control over their pooled pension system and its funds.*

Medical Insurance. *Like old-age pensions, medical insurance was provided solely by the state before the start of economic reforms. Even now, 154 million people enjoy free medical service, according to official statistics, but authorities are working to develop a system that shares responsibility for medical expenses between employees and enterprises. Over 50 cities are*

with special client relationships with state banks will be raised from 300 to 511 and the number of experimental groups from 57 to 120, according to Chinese official press. In addition, the number of cities chosen for a broader reform program that includes provisions for worker retraining, debt relief, and increased bankruptcies of state firms—referred to in Chinese press as the experiment to "optimize the capital structure"—will be increased from 58 to 111.

While China has made some progress on aspects of state enterprise reform—increasing layoffs, for example—property rights reform has proved difficult. Fundamental issues, such as which government agency is ultimately responsible for enterprise performance or has the authority to remove incompetent management, remain unclear. The lack of progress on the so-called 100-enterprise program to pilot the "modern enterprise system"—touted in 1994 as the centerpiece of

experimenting with medical insurance reforms, but the general scheme outlined by the national government requires enterprises to contribute a sum equal to about 10 percent of employees' wages to a social medical fund. Individuals pay a much smaller share of their earnings into private medical insurance accounts. Expenses for minor illnesses are paid out of the individual accounts; the social fund pays for the major costs of serious ailments.

Unemployment Programs. *China has a national unemployment insurance system that is intended to provide relief funds for up to two years for workers who have lost their jobs. It extends, however, only to the outright unemployed and does not cover the millions of underemployed workers at state-owned enterprises receiving subsistence wages:*

- *National leaders recognize the shortcomings of the current system, which are principally its failure to extend benefits to many workers idled by state-owned enterprise reform and its lack of funds. According to a State Council report on poverty, workers and enterprises contribute only 2 percent of the total wage bill toward unemployment insurance. With these problems in mind, officials have made reforming unemployment insurance one of the goals of the Ninth Five-Year Plan.*

- *In the meantime, many localities, such as Beijing, are offering their own unemployment insurance to enterprises. They provide both limited relief funds and help with job training and job placement.*

Beijing's enterprise reforms—reflects the difficulty of sorting out these issues. Most of these enterprises only started implementation of their reform plans in 1996, and an editorial in the flagship *People's Daily* in late 1996 acknowledged that none were close to establishing the system.

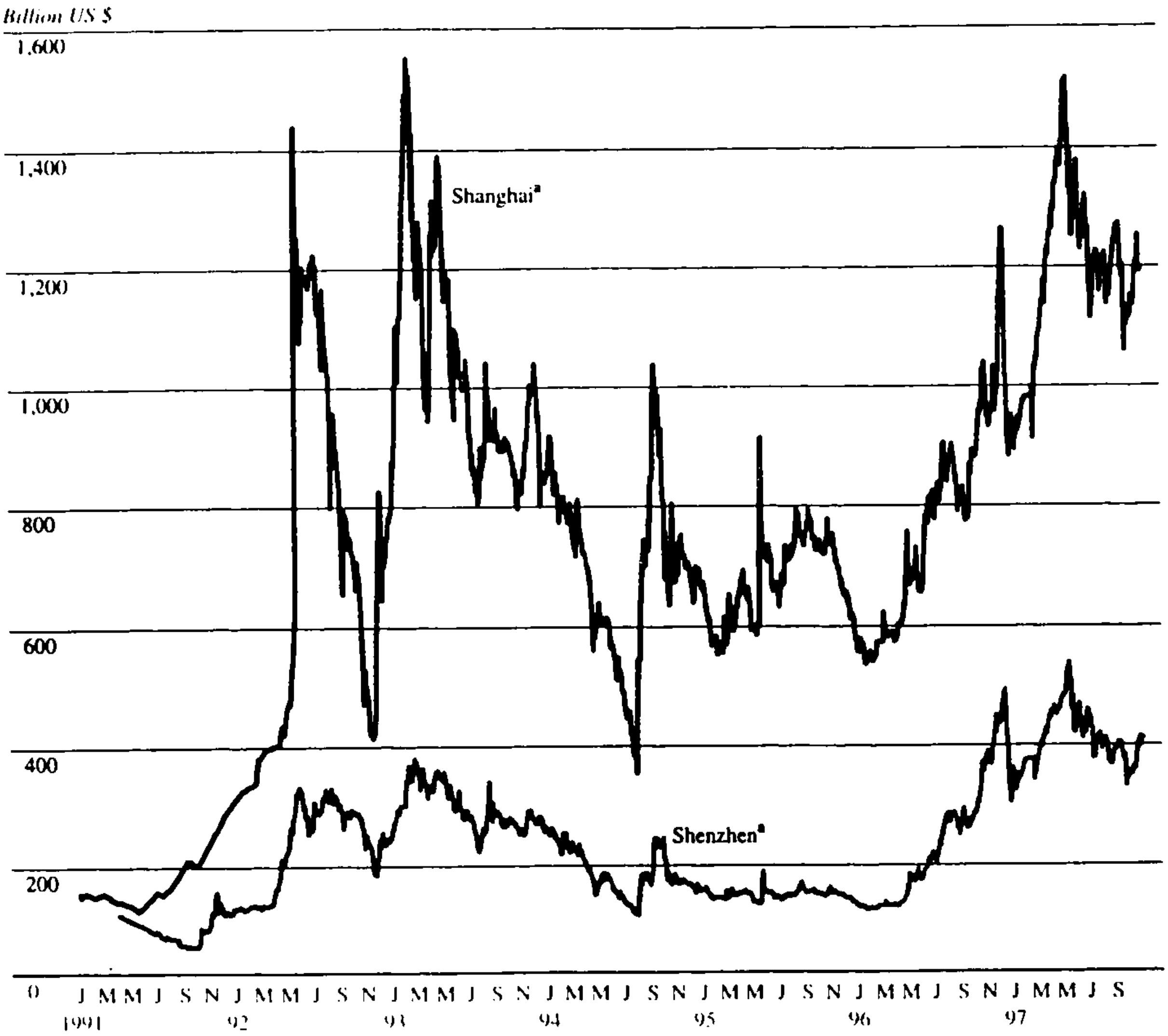
Stepping Up Restructuring. A dominant theme of Beijing's reform plans in 1997 has been preparing for more "bankruptcies, mergers, and reemployment." Two national conferences on the topic were held early in the year, for example, and in mid-April Beijing published a directive announcing a new group—headed by the State Economic and Trade Commission—to coordinate plans for bankruptcies, mergers, and reemployment in 111 cities chosen to pilot enterprise reforms. The directive calls for city officials—with the input of the state banks—to submit plans to the new group specifying enterprises to be bankrupted, to be merged, and to receive public assistance. It also contains detailed regulations for bankruptcies and mergers. Resolving the inevitable disputes among the center, the cities, and the banks during the planning process, however, will probably take some time, and rising unemployment may slow the pace of implementation.

Restructuring the Financial Sector

Beijing took several steps in 1996 to improve the profitability of the state banks. Profits of the four largest state banks that dominate the system dropped sharply from 1992 to 1995, in part because of a program started in 1993 to encourage savings that required the banks to pay inflation-linked subsidies in addition to annual interest payments on savings deposits. In April 1996, the People's Bank of China announced that new deposits would no longer receive such subsidies. Because time deposits from before April 1996 will continue to receive the subsidies, the program will continue to depress bank profits until these accounts expire. Beijing also lowered interest rates on both loans and savings deposits in May and in August 1996, in part to help struggling state enterprises by lowering their interest payments on existing loans. The change also benefited the state banks by widening the gap between loan and savings rates.[2] These changes helped to slightly boost profitability of the state banks. The banks remain in poor financial health, however, in part because of the large volume of nonperforming loans. In 1996 the total profits of the four banks were only 17 billion yuan, according to Chinese

[2] Another interest rate cut in October 1997, in contrast, narrowed the gap between loan and savings rates. Chinese bank officials acknowledged this would shrink state bank profit margins, according to press reports.

Figure 6
China: Stock Markets, 1991-97



[a]Composite index. Includes both A shares, available only to Chinese, and B-shares, available only to foreign investors.

Source: Shanghai and Shenzhen Stock Exchanges.

China's Growing Stock Markets

China's stock markets have expanded rapidly since the beginning of 1996 after languishing for much of 1994 and 1995, hampered by the poor performance of listed state enterprises, Beijing's inconsistent support, and the unclear institutional and regulatory structure. The rapid expansion pushed the major stock indexes by May 1997 close to record highs; Shanghai's A-share index, for example, rose almost 200 percent from early January 1996 to May 1997. Several factors contributed to the rise:

- *Official endorsement of the markets appeared to increase in early 1996, as authorities sharply expanded new issues. The Shanghai and Shenzhen markets listed 63 new firms in the first half of 1996, the fastest rate of new listings in five years.*

- *Stock markets appeared relatively more attractive in 1996 as two interest rate cuts, the repeal of inflation-linked subsidies on savings accounts, and crackdowns on the futures markets reduced returns on other investments.*

- *The widespread perception among investors that Beijing would take measures to ensure a buoyant stock market—and would not intervene to curb speculation—in advance of Hong Kong's reversion also helped boost growth early in 1997.*

Central authorities have also taken numerous steps to tighten market supervision, curb trading irregularities, and discourage the involvement of state banks in the stock market. Indeed, these moves caused sharp falls in the markets in December 1996 and May 1997:

- *Central authorities in the second half of 1996 issued a series of directives to curb market manipulation and strengthen central supervision. In mid-December 1996, in response to a surge in stock prices that started in October, the official* People's Daily *published a front page editorial criticizing excessive speculation, precipitating a sharp fall in stock prices. Beijing's announcement in mid-December that new stock issues in 1997 would be 10 billion yuan—double the previous year's quota—also served to cool the markets.*

- *Starting in early May 1997, central authorities implemented a series of moves to halt illicit trading and the flow of bank funds into the markets, including banning state banks, state enterprises, and listed firms from trading stock on the exchanges; replacing the heads of the Shanghai and Shenzhen bourses; and suspending four brokerages from trading. In August, authorities formally announced that the China Securities Regulatory Commission would henceforth directly control high-level personnel appointments at the exchanges.*

Despite the rapid expansion of China's markets since early 1996, total market capitalization is still relatively small. The importance of the stock markets to the economy may substantially increase during the next three years, as Beijing steps up state enterprise reforms that stress joint-stock ownership. Vice Premier Zhu Rongji, for example, recently told officials in Liaoning Province that the stock markets could become an important source of capital for state enterprises, according to Chinese official press. Despite the apparent high-level endorsement, Beijing is likely to proceed cautiously:

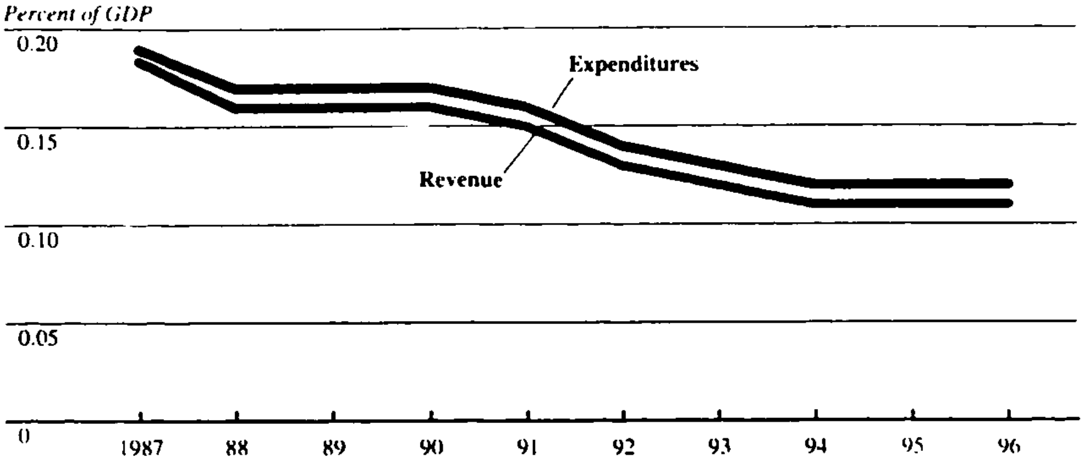
- *China's central bank governor Dai Xianglong, noting the volatility in Thailand's stock markets, recently stressed the importance of avoiding speculative bubbles in the stock market.*

- *The development of China's stock markets continues to be hampered by the unclear regulatory and institutional structure. Beijing's steps to tighten control during the last 18 months have helped clarify lines of authority, but the passage of a proposed securities law has been long delayed.*

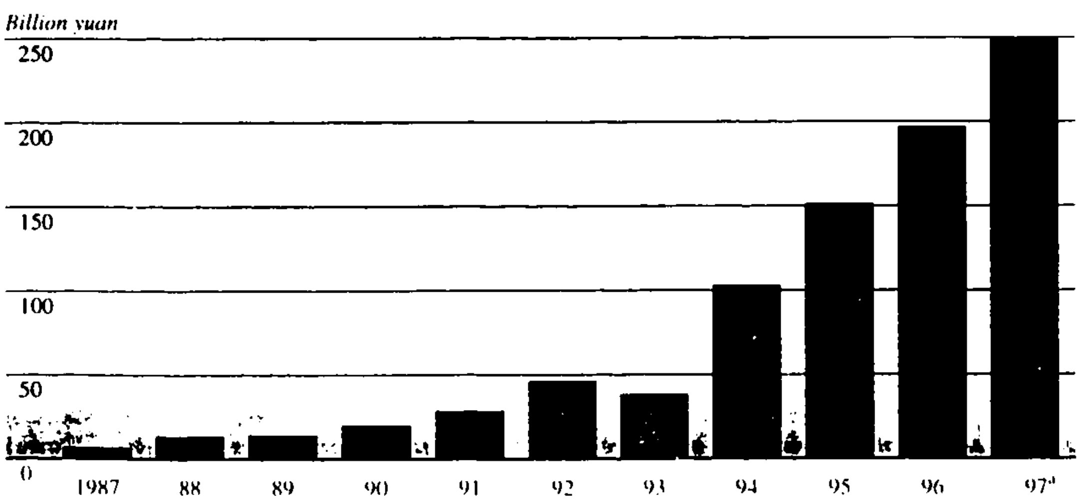
Figure 7
China: Government Budget

Note scale change

China's Government Revenues and Expenditures



Treasury Bond Issues



[a] Planned

Source: Official Chinese Government statistics

official press, half the total in 1992. Since early 1995, Chinese central bank officials have publicly acknowledged that 20 percent of outstanding loans are nonperforming.

Senior officials at the annual national banking conference in January 1997 declared reducing financial risk the top priority for the banking and financial sectors in 1997. As part of this drive, Vice Premier Zhu Rongji called for reducing the percentage of nonperforming loans in bank portfolios by 2 percentage points annually, according to official Chinese press—a goal that will entail further tightening of lending to money-losing state firms. In addition, central authorities have tried to tighten financial regulation of China's trust and investment companies, some of which have incurred large losses because of ill-advised lending. In January 1997 the central bank announced it was closing the second-largest trust and investment company because of mismanagement. Beijing has also, since May 1997, implemented a series of measures to prevent state bank funds from fueling stock market speculation.

Central bank officials also made some progress during the last two years in the bank's long-term program to replace credit controls with more market-oriented policy tools:

- The central bank started open-market operations in April 1996 and the following April issued new rules governing the operations and expanded the number of participants. The program is largely symbolic, however—the volume of tradable treasury bonds is still too small to significantly influence the money supply.

- The central bank also opened a national interbank market for short-term loans—electronically linking 35 regional lending centers with 14 banks—in April 1996. Central bank officials touted the move as the first step in a long-term plan to gradually liberalize interest rates. Market-determined rates for deposits and loans are probably a long way off, however, in part because raising rates to market levels would reduce state enterprise profits.

China's Tax Revenues: Finally Turning the Corner?

Since 1994, when Beijing implemented a new tax system, central authorities have focused on improving tax collection. These efforts have shown some success. Total government revenues in 1996 grew 18 percent—slightly faster than nominal GDP growth—yielding a slight increase in the ratio of revenue to GDP for the first time since economic reforms began in 1978. In addition, the official budget deficit slightly declined in 1997 for the first time in a decade. The official deficit, however, does not include treasury bond issues, which rose sharply from 38 billion yuan in 1993 to 197 billion yuan last year. The fiscal deficit including new government debt is over four times the official deficit but is still manageable at less than 4 percent of GDP.

Central authorities' shift since 1993 to financing the budget deficit through government debt rather than through central bank lending—essentially money creation—has helped the central bank control monetary growth and ease inflationary pressures. Domestic debt levels are still moderate at 5 to 6 percent of GDP, in part because Beijing during the last decade used government-directed lending rather than budget allocations to fund public investment. If Chinese policymakers ultimately resort to budget allocations to recapitalize the state banks and allow them to write off bad loans, debt levels probably would sharply rise. The Ministry of Finance has set a target of eliminating the deficit by the year 2000, but pressures to spend more on infrastructure investment, social security programs, and state enterprise transformation probably will prevent the Ministry from achieving this target.

- In addition, the central bank expanded its use of other indirect methods of credit control, such as rediscounting commercial bills. The bank rediscounted 725 billion yuan of bills in 1996, up 60 percent from the previous year. Nevertheless, credit quotas remain Beijing's primary policy instrument.

Lending by the four largest state banks—which was limited by quotas—accounted for half of total new loans in 1996.

Central authorities have also taken steps to help transform the state banks into commercially viable operations. In August 1996 Beijing issued new "general rules" on bank loans that tighten lending criteria. The rules, for example, limit loan extension periods, prohibit loans for investment in equities markets, and require banks to assign a credit rating to each borrower. Implementation of the rules is far from perfect—the use of bank loans to invest in stocks is still rampant—but the rules provide the banks with another tool to discourage ill-conceived loans. The central bank has also taken steps to gradually replace the practice of assigning credit quotas to each state bank with more flexible policy instruments. By yearend 1995 the central bank had shifted from using credit quotas to asset-liability ratios—which allow banks to lend more if deposits increase—to control credit issuance in smaller commercial banks. Central bank officials started using asset-liability ratios to help determine loan quotas for the four biggest state banks in 1996 and in 1997 have allowed the banks to use the ratios instead of quotas to manage working capital loans, according to Chinese official press.

Central authorities also implemented some measures to encourage competition in the banking sector:

- Beijing in 1996 expanded a program to transform existing urban credit cooperatives into commercial banks, increasing the number of cities authorized to open such banks from 35 to 100. Twenty-three cities have opened or started construction on such banks, according to Chinese press; the rest are still in the planning stage.

- In addition, the central bank, in a long-awaited move, approved eight foreign banks to start domestic currency business in Shanghai's Pudong economic area in early 1997. The scope of the business is sharply restricted: the banks may not conduct yuan transactions with Chinese enterprises or individuals.

- Another step that could, in the long term, promote financial-sector opening is Beijing's commitment in December 1996 to maintain convertibility of the yuan on the current account. Chinese senior officials continue to stress, however, that Beijing has no timetable for achieving capital account convertibility.

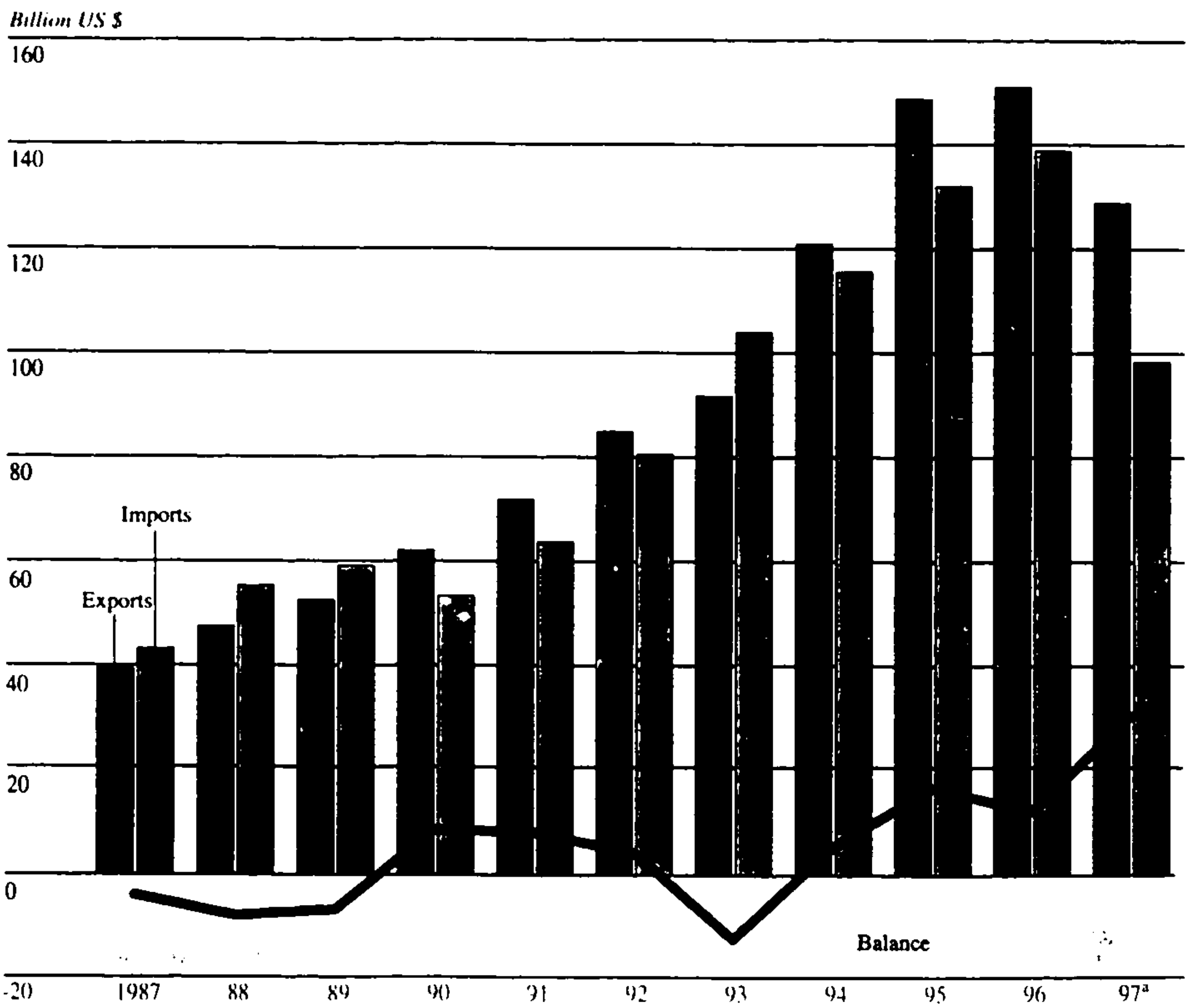
Export Growth Volatile, But Trade Surpluses Continue

Foreign trade's contribution to growth dropped sharply in 1996, as exports grew just 1.5 percent, the slowest rate in over a decade and down from 23 percent in 1995. Most of the slowing in export growth was caused by changes in Beijing's tax and credit policies that raised the costs of exporting. Central authorities cut rebates of value-added taxes for exporters in both July 1995 and January 1996, in effect raising value-added taxes on most exported manufactures from zero to 8 percent. These cuts spurred exports in 1995, as exporters accelerated shipments in advance of the cuts, and slowed exports in 1996, as exporters adjusted to higher costs. In addition, delays in payments of the rebates probably weakened export incentives as much as the cuts did. Over 50 billion yuan in rebates were postponed in 1995, according to official Chinese press, and the backlog carried over into 1996, compounding liquidity problems for Chinese exporters. Many exporting enterprises were already short of cash because of Beijing's generally tight credit policies and a hike in interest rates on loans for exports enacted in mid-1995.

The changes in tax and credit policies primarily affected state enterprises and state trading companies. Foreign-invested enterprises, many of which are not eligible for export tax rebates,[3] were largely unaffected by the changes in rebate policies. The growth of their exports slowed only gradually from 37.5 percent in 1994 to 31 percent in 1996, in part because of increasing competition in many labor-intensive export

[3] Only foreign-invested enterprises established after 1993 were eligible to receive rebates of value-added taxes for exports.

Figure 8
China: Foreign Trade



[a] January-September.
Source: Official Chinese Government statistics.

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industries from other emerging markets. The growth in foreign-invested firms' exports compensated for a 12-percent drop in domestic—that is, nonforeign-invested—enterprises' exports. Foreign-invested enterprises' share of total trade—exports plus imports—rose from 39 percent in 1995 to 47 percent in 1996 because of an absolute drop in domestic enterprises' total trade.

The changes in tax and credit policies sharply increased costs for Chinese exporters and eroded their competitiveness, which already had been weakened by relatively high average inflation—higher than that of China's major trading partners—and stable exchange rates since 1994. In addition, increasing production capacity in other East Asian and Latin American economies contributed to poorer performance in some of China's traditional labor-intensive exports. Exports of textiles, for example, dropped 2 percent in 1996—the first decline in over a decade.

China's dismal export performance in the first half of 1996—exports dropped 8 percent year-on-year—prompted authorities to take steps to encourage exports, and export growth recovered to 10 percent year-on-year in the second half. The recovery accelerated in 1997, as export growth in the first nine months surged to 24 percent year-on-year. Chinese officials have attributed the surge in large part to Beijing's efforts, starting in the second half of 1996, to speed payments of export tax rebates, which helped cut payments in arrears by about half by yearend 1996. In addition, Chinese banks provided exporters in some favored industries such as machinery, electronics, and textiles with preferential access to credit.

Central authorities have also adopted other measures to encourage exports. For example, China's Foreign Trade Ministry in March 1997 expanded the number of domestic enterprises eligible to apply for independent trading rights—and thereby circumvent the state trading companies—and granted producers with annual exports over $10 million the right to establish independent trading corporations. Another trade liberalization measure Beijing undertook in September 1996—which President Jiang Zemin had announced at the Asia Pacific Economic Cooperation organization meeting in September 1995—was the enactment of new policies allowing some foreign firms in partnership with Chinese enterprises to form joint-venture foreign trade companies, albeit under tight restrictions. The new regulations, for example, restrict establishment of such ventures to Shanghai's Pudong district and Shenzhen.

Beijing has focused on expanding exports of medium-technology goods, in part as a response to increasing competition from other East Asian and Latin American economies in labor-intensive exports. Exports of machinery and electronics in 1996 increased almost 10 percent, compensating for a 2-percent drop in other exports, and now account for almost one-third of total exports, according to Chinese statistics. The increase was in part due to preferential credit and tax rebate policies for exporters of these goods. A State Tax Administration directive in June 1996, for example, called for exporters of machinery and electronics to get preference in receiving payments of tax rebates. In addition, excess capacity in the machinery industry pushed producers to expand sales to overseas markets. Beijing in 1997 has continued to promote exports of machinery and electronics. China's Export Import Bank, for example, will expand credit to exporters of machinery and electrical equipment, according to Chinese press reports.

Import growth also slowed from 14.2 percent in 1995 to 5.1 percent in 1996. The decline was largely due to continued tight credit conditions and slower economic growth, which led to excess capacity in many industries and limited demand for imports. In addition, an almost 30-percent drop in cereal imports, prompted by a second straight bumper harvest and rising stores of grain, shaved several percentage points off import growth. Cereal imports had almost tripled in 1995 as authorities tried to raise supplies to slow food price inflation.

Slower industrial growth and faster agricultural growth resulted in a 8-percent decline in domestic enterprises' imports. Foreign-invested firms' imports, however, grew 20 percent in 1996, slightly up from 19 percent the previous year. The increase was largely due to firms accelerating imports of capital equipment to take advantage of lower taxes before the planned

China's Growing Reliance on Imported Oil

China became a net importer of crude oil in 1996 for the first time in two decades, having become a net importer of oil product in 1993. In 1996 crude imports jumped 32 percent higher than 1995 imports to more than 450,000 barrels per day (b/d). Chinese industry experts project that China will import about 1 million b/d of crude by 2000. Middle East oil accounts for nearly half of China's imports, with Oman, Yemen, and Iran being the most important crude suppliers. Imports from Iran more than doubled in 1996 to 46,000 b/d and are expected to rise to about 270,000 b/d after 2000.

China's oil output has failed to keep up with rapidly growing domestic demand. Total apparent consumption—production plus imports minus exports—exceeded 3.5 million b/d in 1996, and many industry analysts expect consumption to grow 5 to 7 percent per year. China produced only 3.2 million b/d of oil in 1996:

- *Onshore production, which accounts for 90 percent of total output, crept up barely 1 percent in 1996. Production from the Tarim Basin in western China rose 24 percent to some 62,000 b/d, but less than China expected.*
- *Offshore production—80 percent of which was from the South China Sea— reached 300,000 b/d in 1996. South China Sea production is near peak, however, and will start to decline in about two years unless new fields are discovered and put on stream. Some foreign oil companies regard the Bohai Gulf as having the best prospects for future offshore China oil development.*

In the first half of 1997, China's oil companies increased their exploration and development activity overseas in major oil-producing regions in the Middle East, Central Asia, and Latin America. China also agreed to build a 3,000-km oil pipeline from western Kazakhstan to Xinjiang but without a firm date for construction. Domestic production in the first half of 1997 slightly increased to 3.3 million b/d, largely because of increases in output from the Tarim Basin and offshore fields.

elimination of tariff exemptions on foreign-invested enterprises' capital imports—announced in April 1996 and originally scheduled to take effect in December 1996 or December 1997, depending on the size of project. China's Foreign Trade Ministry ultimately extended the deadline for exemptions through December 1997 for projects worth less than $30 million and through June 1998 for larger projects.

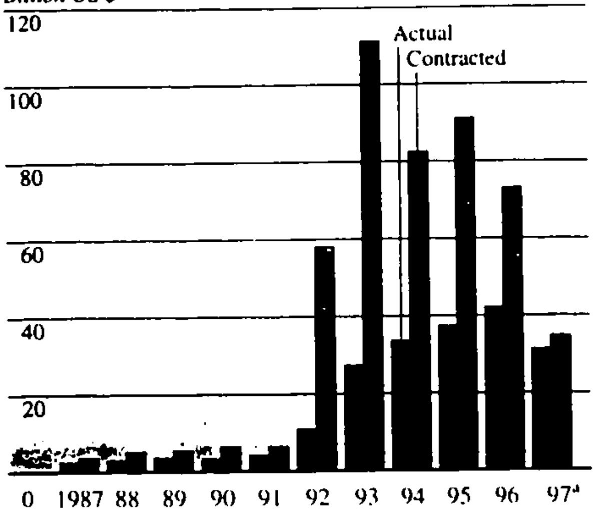
The drop in import growth occurred despite some import liberalization. Beijing on 1 April 1996 cut tariffs on almost 5,000 items, lowering the average nominal tariff rate from 36 percent to 23 percent, and lifted quota restrictions on 176 commodities. These moves failed to stimulate import growth in part because the tariff cuts on manufactures, which account for about 80 percent of Chinese imports, were relatively small. The cuts, generally deepest for raw materials and high-technology items, benefited many domestic industries by lowering costs of imported inputs. The tariff cuts for raw materials, however, also failed to accelerate imports, largely because rapid agricultural growth limited demand for food imports and slower industrial growth limited demand for inputs. Imports of primary goods grew just 4 percent in 1996, down from 48 percent the previous year.

Figure 9
China: Foreign Direct Investment (FDI)

Note scale change

FDI Into China

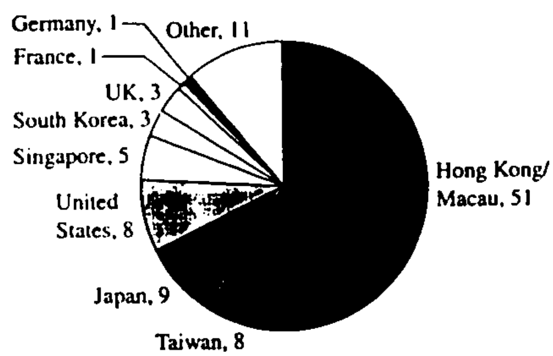
Billion US $



[a] January-September.
Source: Official Chinese Government statistics.

1996 Composition of Actual FDI

Percent



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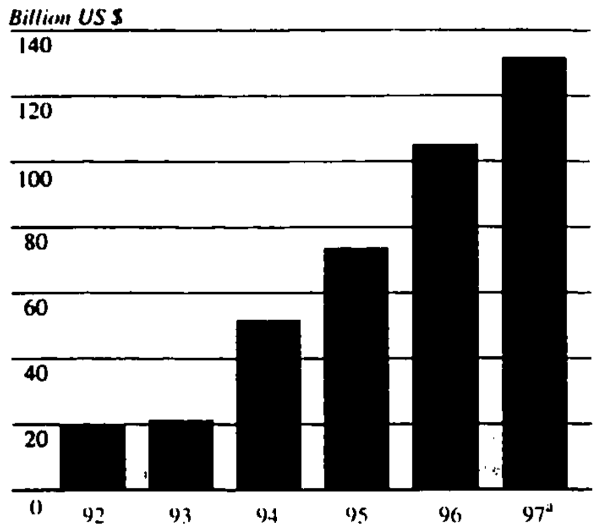
The combination of rapid—though volatile—export growth and a steady decline in import growth has led to substantial trade surpluses during the last two years. The annual trade surplus dipped slightly from $16.7 billion in 1995 to $12.2 billion in 1996 as a result of slower export growth, but in the first three quarters of 1997 alone the surplus surged to $30.5 billion—almost twice any previous annual surplus. An upturn in the economy, which both Chinese Government and foreign private forecasters project for late 1997, would stimulate import demand and slightly reduce the surplus. In the medium term, however, several of Beijing's current policy emphases may help to limit import demand in the next three years and could keep the trade balance in surplus—extending the trend since 1993. These include Beijing's emphasis on economic "restructuring," which entails eliminating excess capacity and may restrain new investment; central authorities' goal of maintaining food self-sufficiency and attendant policy of subsidizing grain production, which will limit grain imports; and the government's stress on increasing layoffs and bankruptcies, which will increase job uncertainty and may restrict consumption. In addition, foreign investment is slowing down—many of the projects in which foreign companies invested during the early 1990s are now operational and exporting finished products, rather than importing capital equipment. Beijing's repeal in April 1996 of duty-free treatment of imports of capital equipment by new foreign firms would also probably slow these imports.

Foreign Investment Remains High Despite Efforts To Direct It

Foreign direct investment in China recorded a new high in 1996 of $42.35 billion—making China again the second-largest recipient of foreign direct investment after the United States. While the volume of foreign direct investment increased, the number of approved projects declined, reflecting a general trend that, while smaller investors are on the decline, medium and large investors are signing new contracts. For example, 200 of the 500 largest multinational corporations have investments in China, according to a Hong Kong economic journal. In addition, the average contractual value of each project in 1996 was roughly 40 percent higher than in 1995.

Although China has continued to record increases in foreign direct investment, the rate of growth is slowing as declines in new investment contracts begin to show up in actual inflows; these grew by 17 percent in 1996—the slowest growth rate this decade. Although the Chinese press claims that the reversion of Hong Kong to the mainland will spur increases in foreign direct investment—to reach $49.5 billion in 1997, 17 percent greater than in 1996—China's changes to preferential tax policies for foreign investors and steps to further control inflows may further slow foreign direct investment growth in 1997 and 1998.

Figure 10
China: Official Foreign Exchange Reserves



[a]Data through end of September.

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Encouraging Inland Investment
Since 1995 Chinese leaders have increasingly tried to direct foreign direct investment to preferred sectors or regions through industrial policies, foreign investment guidelines, and other measures. One of the more recent efforts was a State Council circular issued in August 1996, which extends to inland provinces and various State Council ministries approval authority for foreign investment projects valued at as much as $30 million, rather than the previous $10 million ceiling. Beijing has also stipulated that over 60 percent of loans from international financial institutions and foreign governments be used in central and western areas. Provincial authorities have also taken steps to direct foreign investment. Authorities in Sichuan Province, for example, have drafted plans to provide incentives such as tax breaks, favorable export policies, and relaxed land-use regulations for foreign investors. Chinese statistics suggest that these policies have been partly successful. Foreign direct investment in the hinterland grew 27.2 percent in 1995, as compared with 11-percent growth in coastal areas. As a result, foreign capital used in interior regions in China accounted for more than 10 percent of the national total in 1996, a slight increase over 1995.

Changing Composition of Investment Sources
According to official Chinese statistics, US investment in China grew 12 percent in 1996, making the United States the fourth-largest investor in China—closely following Hong Kong, Japan, and Taiwan—but the holder of the most new contracts for foreign direct investment projects. Though it is still only the

fifth-largest investor in China, South Korean investment has seen the fastest growth over the past few years, with a 41-percent increase in the value of new contracts in 1996. Hong Kong remains the largest investor in China—in part because it serves as an entrepot for investment from other sources. Its share of total foreign investment in China, however, has steadily declined since 1993, when it accounted for 68 percent of total foreign investment, to only 50 percent in 1996.

Challenges Ahead: Sustaining Growth While Deepening Reforms

After four years of moderate austerity and gradually slowing growth, China may be near the bottom of its business cycle. Beijing's sustained monetary restraint has raised unemployment pressures, and inflation is below the most stringent targets cited by Chinese officials. Because of these and other indicators, both Chinese Government and many foreign business analysts early this year projected a slight acceleration in investment and growth in 1997. China's next economic upswing, however, will probably bear little resemblance to the last one—an unfettered boom in locally initiated investment that started in 1992 and led to rapid growth of the money supply and accelerating inflation. The changes in the economic landscape that have taken place in the last two years suggest that growth will be slower, inflation lower, and central control over the direction of investment greater during the next economic upswing.

Indeed, the widely anticipated economic upturn did not materialize in the first three quarters of 1997. GDP growth was 9 percent year-on-year, down from 9.7 percent for all of 1996. Moreover, this slight decline masked a more substantial shift in the sources of growth. The surge in exports in the first three quarters of this year—which accounted for 3 to 4 percentage points of GDP growth—compensated for slower domestic investment. Slower domestic growth was in part due to Beijing's decision to accelerate difficult structural reforms. Central authorities' stress on layoffs and bankruptcies, for example, probably helped restrain wage increases; real urban per capita income in the first three quarters grew just 3 percent year-on-year, as compared with an average 7 percent annual increase since 1990.

China's economic performance in the first half of 1997 illustrates the trade-offs facing Beijing. Central leaders' statements and policies show that, in their view, the government must move ahead with difficult reforms to sustain long-term growth. These reforms have costs—such as plant closings and increased unemployment—and may slow growth in the short term. Putting off these reforms, however, will merely raise their ultimate cost and, in the long term, increase the chance of a crisis in the banking sector. Nonperforming bank loans are already equal to over 18 percent of GDP, according to estimates cited in the Chinese press—far in excess of what Beijing could cover through budgetary allocations without steep increases in taxes or government debt.

At the same time, Chinese policymakers seek to maintain rapid enough growth to create jobs for new entrants and displaced workers and thereby avoid destabilizing levels of unemployment. The Ministry of Labor estimates that 54 million new jobs will be required in urban areas during the Ninth Five-Year Plan (1996-2000) but that the economy will only generate 38 million. In addition, a slowdown in growth, by increasing loan defaults, could precipitate the very financial crisis Beijing is trying to avoid. Banking officials may view sustaining fast development—and, if possible, boosting the growth of *performing* loans—as the easiest way to recapitalize the state banks. Further complicating economic decision making, Beijing retains an ideological commitment to public ownership—although the nature of that commitment is changing.

These conflicting goals have shaped Beijing's approach to economic reform since 1995, and the main elements of economic policy probably will continue. China's central bank governor in August 1997, for example, stressed Beijing will sustain "moderately" tight monetary policies for several years, and the 15th Communist Party Congress in September 1997 strongly reaffirmed the two-pronged approach to state enterprise reform under which Beijing focuses support on larger state firms.

Recent public statements suggest, however, that senior leaders intend to accelerate structural reforms during

the next three years. President Jiang Zemin's keynote speech at the Congress, for example, constituted the strongest official endorsement to date of more aggressive ownership reforms—in particular, the conversion of state firms into joint-stock companies. Moreover, senior officials have cited ambitious targets for restructuring the state sector. Vice Premier Zhu Rongji, for example, recently said that by 2000 most money-losing large and medium-sized state firms should be profitable, while other officials have predicted that the reform of small state enterprises will be complete by that date, according to press reports.

Although rising unemployment pressures and bureaucratic opposition may temper progress on these goals, Beijing appears likely to continue market-oriented reforms. What type of market economy will result, however, is still unclear. Many of Beijing's enterprise reform initiatives—the wave of mergers sweeping the country, the experiments with enterprise groups and holding companies, and the cooperative agreements between banks and large enterprises, for example—appear inspired by the Japanese *keiretsu* or Korean *chaebol* systems. Although there are plausible reasons for these initiatives—takeovers of money-losing firms may improve management, for example—they may yield a system dominated by state-affiliated conglomerates in which economic power is highly concentrated and a few interest groups have an inordinate effect on government policy. On the other hand, Beijing continues to pass new economic legislation and establish institutions that may help to limit arbitrary government intervention in the economy. Developments during the next three years will help determine whether China's economy will be characterized by close linkages between government and industry and a high concentration of economic power, or whether it will be a more transparent system with greater reliance on the rule of law.

Appendix

China's Bilateral Trading Relationships in 1995 and 1996

China remains competitive in several of its traditional labor-intensive industries, such as toys and sporting goods, but greater foreign investment and, to a lesser extent, Beijing's efforts to upgrade technology-intensive industries have raised exports of medium-technology products. Foreign investment, for example, has helped raise exports of electrical machinery to nearly all of China's major trading partners, and the sector has now overtaken textiles as the largest export category. China's fastest growing export in 1996 was chemical fertilizers, an industry that Beijing has been attempting to upgrade.

Meanwhile, despite some market liberalization over the past few years—including tariff reductions, elimination of nontariff barriers, and expansion of trading rights—China's trading partners saw most key sales grow only slightly or decline because of continued Chinese import restrictions on many items—such as autos and chemicals—and macroeconomic factors, such as slow economic growth and investment. As a result, over the past two years, most of China's major trading partners have experienced growing trade deficits with China—with the exception of South Korea, whose producers have rapidly expanded exports to supply their growing manufacturing investments in China.

Rapid Expansion of US Trade

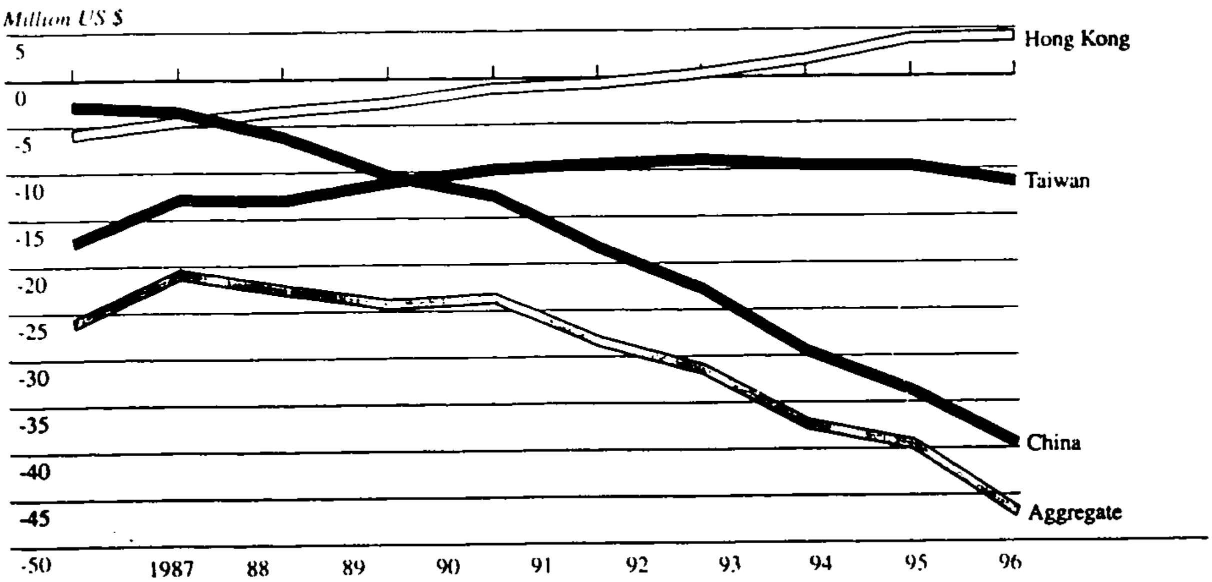
US exports to China grew more than 26 percent in 1995—reaching $11.8 billion and growing at almost twice the rate of US sales to the world over the same period. Sales to China in 1996, however, leveled out—growing just over 2 percent, while US sales to the world were up almost 7 percent. US imports from China continued their strong growth, increasing 17 percent in 1995 and 13 percent in 1996—nearly double the rate of growth for US imports from the world in 1996. As a result, the Chinese surplus with the United States grew from $33.8 billion in 1995 to $39.5 billion in 1996.[1]

The rapid growth in US sales to China in 1995 was driven primarily by exports of agricultural products, particularly cereals and vegetable fats and oils, which outstripped global sales of these goods. Indeed, exports to China of vegetable fats and oils—primarily soybean oil—almost tripled, while cereal sales—dominated by corn and wheat—grew almost sixfold. Large buildups of food stocks and improved harvests, however, combined to reduce demand for agricultural imports in 1996; corn purchases from the United States, for example, dropped 98 percent from the previous year. In contrast to the general trend, however, US farmers saw dramatic annual increases in sales of soybeans to China in both 1995 and 1996.

US producers of high-technology goods recorded increases in their sales to China and roughly maintained their market share in 1995 and 1996. For example, the United States held between 7 and 9 percent of China's market for industrial machinery and mechanical appliances in those two years. While aircraft sales—which tend to be volatile because of the large dollar value of individual shipments—continued to decline in 1995, they grew 45 percent in 1996, outstripping the growth of US sales to the world in this sector by nearly 20 percentage points. US pharmaceutical manufacturers are also recording some success;

[1] Chinese statistics recorded a surplus with the United States totaling $10.5 billion in 1996. Most of the differences between the two data sets are caused by valuation variations and different methods of accounting for transshipments through Hong Kong and other countries. As these factors also affect China's trade with other countries, all bilateral statistics are derived from data provided by China's trading partners rather than Chinese data, unless otherwise noted.

Figure 11
US Trade Balance With China, Hong Kong, and Taiwan, 1987-96



Source: Official US trade statistics.

360477AI7 11-97

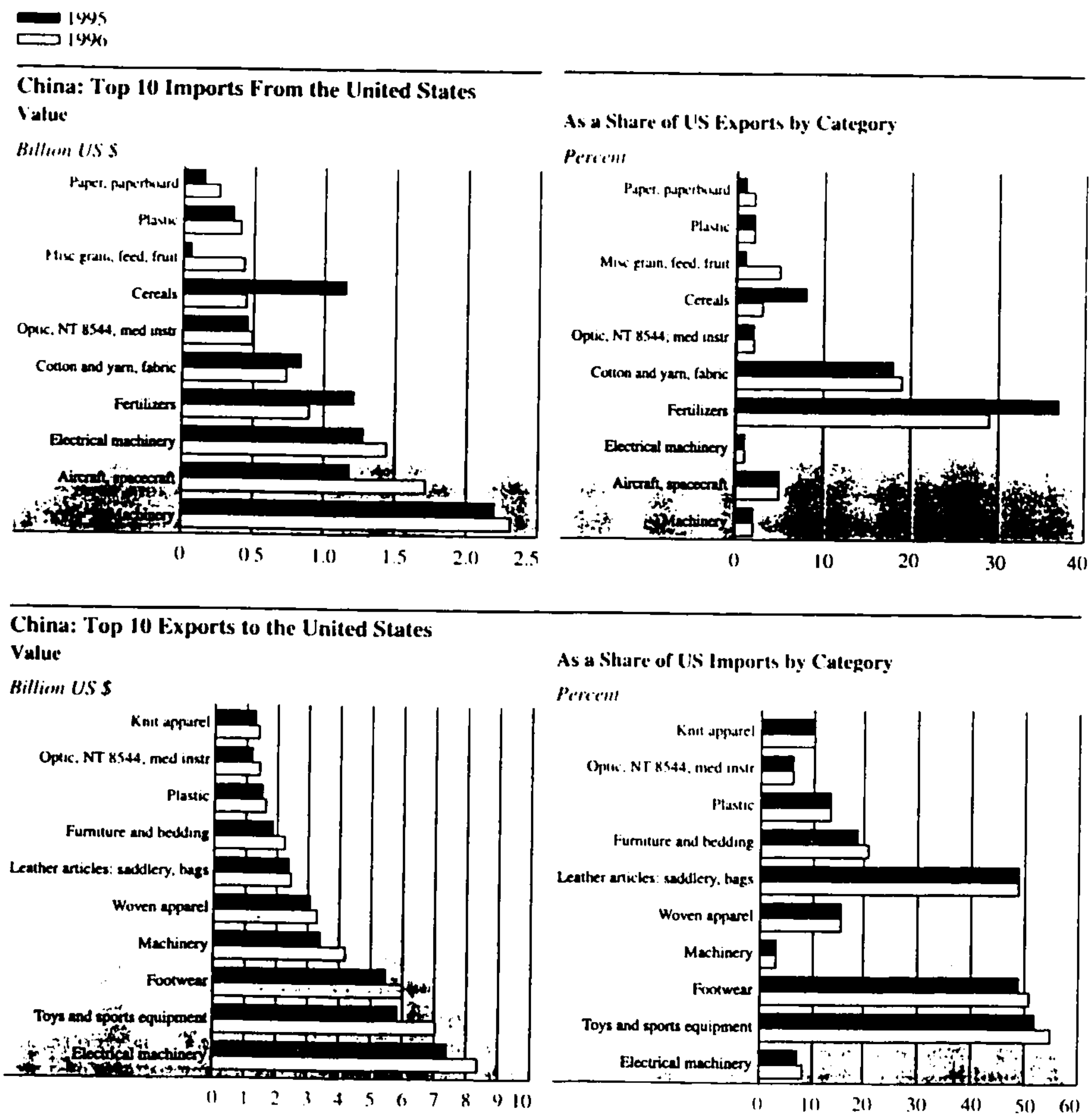
their share of China's imports of pharmaceuticals has steadily increased and reached 15 percent in 1996, up from 6 percent in 1992.

China saw mixed success with its exports of labor-intensive goods to the US market. China's exports to the United States of furniture and toys grew by more than 20 percent in 1995 and 1996—outstripping the growth in China's global sales of these goods. Chinese apparel sales to the United States—which fell in both 1994 and 1995—showed a modest recovery in 1996, growing 8 percent; this increase stopped the gradual erosion of China's share of US clothing imports. Leather goods, on the other hand, were unable to keep pace with their rapid growth earlier in the 1990s and grew less than 5 percent in both 1995 and 1996; Chinese producers, however, still hold an almost 50-percent share of US imports in this sector.

Growth in Chinese sales to the United States of more technology-intensive goods—which have been among the most dynamic of China's export sectors—slowed in 1996 after another year of fast growth in 1995. Some of these products—including machinery and photographic and measuring equipment—in 1996 grew at less than half the rate they did in 1995. Nevertheless, China's exports of technology-intensive goods to the United States expanded faster than overall

Figure 12
The Structure of Sino-US Trade[a]

Note scale change



[a] Products are ranked on 1996 data. Data in these charts are based on Harmonized System Nomenclature (HSN) two-digit-level product classifications and are not comparable to the Standard International Trade Classification (SITC) series used in previous reports, although the level of aggregation is roughly similar.

Source: Official US trade data.

360478AI7 11-97

Chinese exports to the United States and, in addition, outstripped the growth of US global imports in these sectors. Chinese sales of electrical equipment and appliances—primarily small electrical appliances such as radio receivers and space heaters—now account for 8 percent of US imports of these goods.

Japan Remains Important Export Market

China remains Japan's second-largest supplier of imports, after the United States, and sales to Japan now account for roughly one-quarter of total Chinese sales to the world. Despite Japan's success in China's market in 1995—sales were up almost 17 percent—imports from China increased nearly 30 percent. China's trade surplus with Japan grew in 1996 as Chinese exports rose almost 13 percent and imports from Japan were virtually stagnant. These trends pushed China's surplus to $18.6 billion by the end of 1996, more than double the surplus in 1994.

Continued increases in Chinese exports to Japan in such areas as apparel, leather goods, toys, and prepared meat and fish allowed Chinese producers to capture roughly one-third to two-thirds of Japan's total imports of these goods by yearend 1996. China's success in the Japanese market, however, continues to create tension in the bilateral relationship as Japanese textile producers again sought action from Tokyo to limit imports of Chinese products. Despite claims that Chinese manufacturers failed to abide by voluntary quotas agreed to in 1995, Beijing and Tokyo established a similar system in 1996.

Goods higher up the technology ladder continue to rank among China's fastest growing exports to Japan—probably as a result of growing Japanese manufacturing investments in China. Chinese sales to Japan of machinery roughly doubled in 1995 and increased 80 percent in 1996. Parts for office machines and computers and computer parts—which make up the bulk of Chinese sales to Japan in this sector—together grew 130 percent in 1995 and nearly doubled in 1996. Moreover, in 1996 China surpassed South Korea as the second-largest supplier to Japan of imported electrical equipment and now accounts for 12 percent of all Japanese purchases in this sector. Exports of photographic and measuring equipment also grew rapidly in 1995 and 1996. China—whose sales in this category were dominated by photocopiers and still cameras in 1995—surpassed both Taiwan and the United Kingdom to become the third-largest supplier to Japan of this category of goods; nevertheless, China has only a 6-percent share of this market, which remains dominated by the United States.

In the future, China's success in this market may have drawbacks as some producers become dependent on the Japanese market. Japan already purchases more than half of all Chinese sales to the world of knitted apparel and wood products and over 40 percent of Chinese nonknit apparel and umbrellas and walking sticks. China's more technology-intensive products—driven in many cases by Japanese investment on the mainland—face similar patterns; roughly 20 percent of Chinese exports of electrical equipment as well as photographic and measuring equipment are destined for Japan.

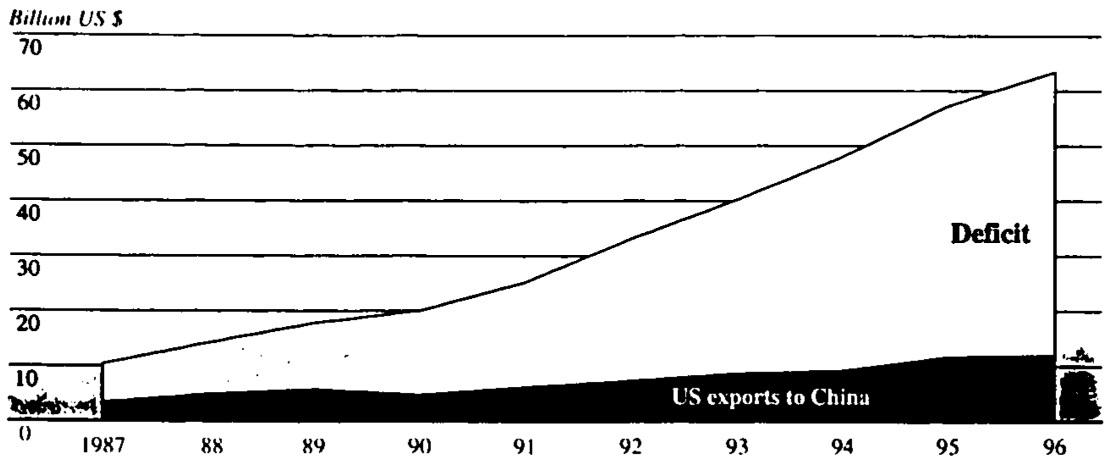
Declines in total Japanese exports to China were driven by falling sales of electrical equipment, iron and steel, and iron and steel products—all of which rank among Japan's top-five exports to China. Japan still holds roughly one-quarter of China's market for these goods, although its share in some cases is declining. Japan's share of Chinese imports of iron and steel products fell from 42 percent in 1993 to 23 percent in 1996. Despite the poor showing in these sectors, some Japanese producers continued to score gains, possibly because their goods are used as inputs for Japanese-invested factories on the mainland. Machinery imports in 1996 from Japan were up a modest 5 percent, while woven fabrics increased more than 15 percent and plastics almost 13 percent.

EU Sees Growing Trade Deficit With China

As the European Union's overall deficit with China grew by more than 26 percent annually in 1994 and 1995. European countries—and the EU collectively under the auspices of World Trade Organization negotiations—are among China's trading partners pushing for greater access to China's market. After growing 9 percent in 1995, China's imports from the EU fell nearly 5 percent in 1996—led by declines in imports

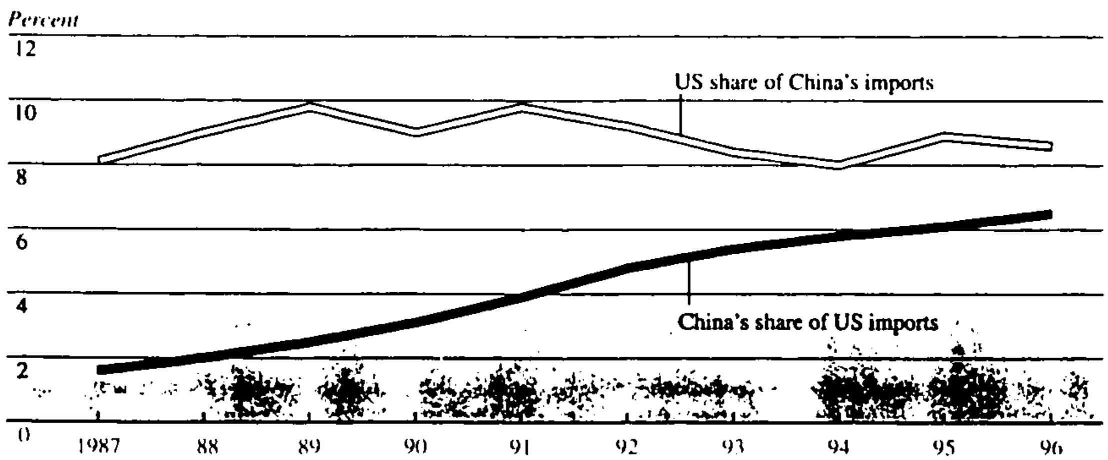
Figure 13
Chinese Gains in US Market Drive US Trade Deficit

The US trade deficit with China . . .



Source: Official US trade statistics.

. . . is largely attributable to Chinese gains in the US market.



Source: Official US and Chinese trade statistics.

360479AI7 11-97

of fats and oils, vehicles and boats, iron and steel, and cereals. Meanwhile, China's exports to the EU grew nearly 17 percent in 1995 and more than 11 percent in 1996. The EU has traditionally restricted imports of such Chinese goods as footwear, apparel, and toys, and, except for toys, China continued to see sales of these goods decline in 1995. Nevertheless, China's exports to the EU of each of these goods increased by as much as 30 percent in 1996. Although the EU in June 1996 decided that, effective in 1997, it would remove or increase quotas on a number of Chinese products—including car radios, shoes, and ceramics—it maintained the quota on toys, imposed import restrictions and new duties on some items in late 1996, and filed a number of antidumping cases targeting Chinese exports of shoes, bags, and unbleached cloth.

China's trade surplus with *France* grew by almost 90 percent from $1.9 billion in 1994 to $3.5 billion in 1996 as Chinese sales to France surged. Machinery exports to France—particularly computer parts—more than doubled in 1995 and grew by more than 75 percent in 1996, raising it from the seventh- to the third-largest category of exports to France. Chinese efforts to develop its chemicals industry appear to have achieved success; exports to France of organic chemicals grew 60 and 87 percent in 1995 and 1996, respectively.

French exports to China remain relatively small—accounting for less than 1 percent of France's global sales and only 2 percent of China's total imports—and declined by more than 10 percent in 1996 after a sharp upswing in 1995. The drop in 1996 was led by declines in French sales of machinery—particularly internal combustion piston engines—and electrical equipment. Increased Chinese domestic demand for foodstuffs in 1995 coupled with improved Sino-French relations spurred Beijing to purchase more than $280 million of French wheat and barley in 1995—after buying virtually no French cereals in 1994. Nevertheless, in 1996, French cereal exports plummeted more than 90 percent as China's domestic harvest improved. French aircraft sales, however, which -- like US exports --suffered from the 60-percent decline in Chinese global aircraft imports in 1995, were up 40 percent in 1996.

China's surplus with the *United Kingdom* reached over $6 billion last year—up by over one-quarter for each of the last two years. Footwear has consistently been among the fastest growing Chinese exports to the United Kingdom, and in the past two years China has surpassed suppliers such as Brazil and Ireland to become the fourth-largest supplier of shoes to the British market—accounting for almost 10 percent of British imports of these goods. China—which with Hong Kong is the top exporter of apparel to the United Kingdom—saw its clothing sales to the United Kingdom rebound in 1996 after two years of stagnant or declining exports. British sales to China, on the other hand, fared less well, growing only 3 percent in 1995 and falling 11 percent in 1996. UK exports of machinery, electrical appliances, and scientific and measuring instruments—three of the top four categories of British exports to China—all faced declines last year in purchases by Chinese customers.

A dramatic slowdown in Chinese sales to *Italy* led to a 5-percent decline in China's surplus with Italy in 1996, following a 43-percent increase in the surplus in 1995. China registered 3-percent growth in exports to Italy last year; sales were hindered by the second straight year of falling Italian purchases of Chinese goods. The 6-percent increase in Chinese imports from Italy in 1996 was led by a 16-percent increase in machinery sales—primarily textile-related machinery. Machinery accounts for more than two-thirds of all Italian exports to China.

German exports made a strong showing in the China market in 1995—up more than 17 percent—that they were unable to repeat in 1996. Vehicle sales, for example, were up almost one-third in 1995 but fell more than 36 percent in 1996. Machinery, Germany's top sector for exports to China, increased 9 percent in 1996, falling short of 1995's 15-percent rise. Chinese clothing exports rebounded in 1996—knit apparel was up 13 percent—after declining in 1995. Sales to Germany of machinery and electrical equipment, on the other hand, declined in 1996 after a strong performance in 1995. German purchases of Chinese machinery—dominated by office machine and computer parts—for example, rose 63 percent in 1995 but fell by 7 percent in 1996.

South Korea Shows Biggest Gains Among Other Trading Partners

Two-way trade between China and *South Korea* continued to grow rapidly over the past two years. Chinese imports from South Korea grew by almost one-half in 1995 and were up by roughly one-quarter in 1996 despite less than 5-percent growth in South Korea's sales to the world last year. Chinese exports to South Korea also grew rapidly—up 35 percent in 1995 and 15 percent in 1996.

China, however, ran a $3.4 billion trade deficit with South Korea in 1996, in part because Korean companies are benefiting from demand from their investments in China. Contracted South Korean investment in China increased 41 percent in 1996—making South Korea China's fastest growing investor. South Korean sales to China of parts of footwear, for example, increased 67 percent last year and were up 87 percent in 1995. Exports of manmade filaments and fabrics as well as impregnated textile fabrics both grew more than 40 percent in 1995 and 1996. South Korea is also gaining ground in areas traditionally held by Western and Japanese suppliers; by the end of 1996, South Korean producers accounted for 12 percent of Chinese imports of iron and steel and 7 percent of Chinese imports of electrical machinery.

China's trading patterns with South Korea reflect its global export trends. China's success in moving up the technology ladder, for example, is evident in increases of between 60 and 100 percent in exports to South Korea of machinery, electrical appliances, and photographic and measuring instruments in 1995 and 1996. Sales of iron and steel to South Korea, on the other hand, fell by 11 percent last year—at the same time that Chinese iron and steel exports to the world fell by more than one-third. Despite this drop, South Korea now absorbs roughly 33 percent of all Chinese iron and steel exports—up from 17 percent in 1993.

High-level visits between *Russian* and Chinese officials have sought to reverse declining bilateral trade. These diplomatic initiatives appear to have benefited Russian exports to China, which increased more than 35 percent in 1996, according to Russian statistics. Chinese purchases of Russian military equipment have also contributed to growing bilateral trade.

Chinese sales to Russia, however, continue to be hindered by Russian perceptions that Chinese goods are low in quality, according to Russian press reports. Indeed, Chinese exports to Russia fell in 1995 and grew less than 2 percent in 1996. Nevertheless, China is Russia's third-largest trading partner outside the countries of the former Soviet Union. Moreover, official estimates of trade do not include border trade, which Russian press reports claim may account for $500 million to $2 billion worth of goods, or between 7 and 30 percent of officially reported trade in 1996.

Cereals account for roughly 35 percent of *Canada's* exports to China and—despite relatively smooth political relations—changes in Chinese domestic grain supplies led to large swings in the Sino-Canadian trade balance. Chinese imports of Canadian cereals increased 91 percent in 1995, cutting Canada's trade deficit with China by one-fifth despite a sharp decline in Chinese purchases of Canadian electrical equipment—the second-largest category of imports from Canada. With improved harvests in 1996, however, imports of Canadian cereals fell 13 percent. This decline, coupled with another large drop in Canadian electrical equipment exports, led to a 15-percent decline in overall Canadian sales to China in 1996 and a two-thirds increase in Canada's bilateral trade deficit. Growth in sales to Canada of Chinese electrical equipment—its largest export category—slowed in 1995 and 1996; exports in this sector were up only 6 percent in 1996, down from 42 percent growth in 1994. Chinese machinery sales to Canada, however, continued to grow rapidly—up by 50 percent in 1995 and 45 percent in 1996—and displaced nonknit apparel, footwear, and leather goods to become China's third-largest export to Canada in 1996.

Despite tensions in the *Taiwan* Strait in March 1996, cross-strait trade increased 4 percent last year, according to estimates by Taiwan's Board of Foreign Trade. The increase was probably spurred by increasing purchases by the island as Taipei made some progress in liberalizing restrictions on imports from the mainland. Taipei also eased limitations on visits by economic and trade personnel from the mainland. At the same